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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1979

No. 79-509

EXXON CORPORATION,
Appellant,

v.

WISCONSIN DEPARTMENT OF REVENUE,
Appellee.

On Appeal From the Supreme Court of Wisconsin

MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE AND BRIEF AMICUS CURIAE OF THE MULTISTATE TAX COMMISSION AND PARTICIPATING STATES

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MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE

The Multistate Tax Commission (Commission) and the participating states listed herein respectfully move for leave to file the attached Brief *Amicus Curaie* in this case. The consent of the attorney for the Appellee has been obtained. The consent of the Appellant has been requested but has not been granted.

The interest of the Commission is as shown in the "Statement of Interest" section of the attached Brief. As

stated therein, this case is of fundamental importance to the Commission and all of the income tax states, including those states which have joined in this brief.

WHEREFORE, it is respectfully requested that this Court grant the Commission permission to file the accompanying amicus brief in this cause.

Respectfully submitted,

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IN THE

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NO. 79-509

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v.

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BRIEF OF MULTISTATE TAX COMMISSION AND PARTICIPATING STATES ON BEHALF OF APPELLEE

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BRIEF AMICUS CURIAE OF THE MULTISTATE TAX COMMISSION AND PARTICIPATING STATES

STATEMENT OF INTEREST

The Multistate Tax Commission (hereinafter referred to as the "MTC") is the administrative agency of the Multistate Tax Compact entered into currently by 19 states as full members and by 12 states as associate members.[1]

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1 The current regular members are the states of Alaska, Arkansas, California, Colorado, Hawaii, Idaho, Kansas, Mighigan, Missouri, Montana, Nebraska, New Mexico, Nevada, North Dakota, Oregon, South Dakota, Texas, Utah and Washington. The associate members are the states of Alabama, Arizona, Georgia, Louisiana, Maryland, Massachusetts, Minnesota, New Jersey, Ohio, Pennsylvania, Tennessee, and West Virginia. (Ninth Annual Report, Multistate Tax Commission, June 30, 1976.)

The purposes of the Compact are to:

1. Facilitate proper determination of State and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes.

2. Promote uniformity or compatibility in significant components of tax systems.

3. Facilitate taxpayer convenience and compliance in the filing of tax returns and other phases of tax administration.

4. Avoid duplicate taxation.[2]

The MTC seeks uniformity in state tax treatment of multistate-multinational businesses, and fairness and equity between such businesses and smaller in-state businesses. It is also working to advance effective enforcement of state corporate tax laws, and seeks policies which are simple and comprehensible for public officials and business taxpayers alike.

In fulfillment of these objectives in the area of state income taxation of multistate-multinational businesses, Article IV of the Compact sets forth the provisions of

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2 The constitutionality of the Compact was upheld in *U.S. Steel Corp. v. Multistate Tax Commission*, 434 U.S. 452 (1978), affirming 417 F. Supp. 795 (S.D.N.Y. 1976). This Court there noted that the Compact ". . . symbolized the recognition that, as applied to multistate businesses, traditional state tax administration was inefficient and costly to both State and taxpayer."

the Uniform Division of Income for Tax Purposes Act (UDITPA).[3]

It is important that this language be interpreted to carry out the purpose of the 29 states in adopting UDITPA. This purpose is to provide for uniformity and full accountability (without duplication) in the division of income for state income tax purposes by workable and rational division of income rules.

Pursuant to its authority under Article VII of the Compact, on February 21, 1973, the Commission approved revised uniform allocation and apportionment regulations which implement UDITPA. It is estimated

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3 UDITPA was promulgated by the National Conference of Commissioners on Uniform State Laws in 1957 (Uniform Laws Annotated, Vol. 9a, p. 448 et seq). It has been adopted by a great majority of the income tax states (Eleventh Annual Report of the Multistate Tax Commission (1977-1978), Appendix B, p. 28). Its purpose is to provide for the uniform allocation and apportionment of income for state income tax purposes by those states that adopt it. Section 1(a) defines "business income" which is subject to apportionment as:

> ". . . income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."

Section 1(e) defines "nonbusiness income" which is subject to specific allocation as ". . . all income other than business income."

that 18 states have adopted these regulations substantially in the form as adopted by the Commission.[4]

Within the framework of these regulations and otherwise, the Commission has sought to devise and participate in the development of practical and reasonable rules for the division of income among the respective states and other jurisdictions where multinational corporations conduct their business activities.

The objective of these practical and reasonable rules is to insure to each state a tax result reasonably related to the privileges and benefits conferred by each state on a multistate-multinational corporation without subjecting it to any duplicate taxation. In our judgment, this objective cannot be achieved by the "separate accounting" of Exxon[5] in the instant case. The fact that Exxon's executives and its other expert witnesses may conclude, as a general proposition, that Exxon has "separately accounted" for its marketing income under generally accepted accounting principles for internal management purposes is an inadequate resolution of the complexities involved in "separate accounting" for taxes on or measured by "net income." It is the detailed examination of every transaction and not the opinions and conclusions of experts which is involved in any proper application and policing of "separate ac-

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4 Results of a Survey on the Uniformity of State Laws by the State of Indiana dated February 15, 1977.

5 Although the taxpayer for the years involved was Humble Oil and Refining Co., since it was merged into Exxon and Exxon has assumed Humble's liabilities, we will refer to the taxpayer here as Exxon or appellant.

counting" by the states.[6] Furthermore, "separate accounting" is predicated on many arbitrary adjustments of income and expenses which cannot be resolved by any meaningful objective standards. Such adjustments can materially shift "net income" and involve endless controversy over proper attribution of net income to particular jurisdictions. It is because of this that "separate accounting" has generally been rejected by the

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6 See Dexter, "Article 9(4) of the United Kingdom Tax Treaty Should Be Reserved," Nolan, "The U.K. Tax Treaty Should Be Ratified Without Reservation," and Dexter, "A Closing Response to Mr. Nolan's Views," Special Report, *Tax Notes*, April 17, 1978, p. 403-416, where the authors debate the problems for the states associated with "separate accounting" as compared to formulary apportionment for worldwide "combined reporting" purposes. Both agree that "separate accounting," even in a "combined report," is not workable at the domestic level. As noted in Hellerstein, "The Unitary Business Principle and Multicorporate Enterprises: An Examination of the Major Controversies," 27 *The Tax Executive*, July 1975, No. 4 at p. 315:

> Over the years, separate accounting has come in for increased criticism, in theory as well as because of its impracticability and excessive costs. (Citing Albert H. Cohen, "Apportionment and Allocation Formulae and Factors Used by States in Levying Taxes Based on or Measured by Manufacturing, Distributive and Extraactive Corporations," Research Report prepared for Controllership Foundation (1954) and "State Taxation of Interstate Commerce," Report of the Special Subcommittee of the Judiciary Committee ("Willis Subcommittee"), 88th Congress, 2nd Session, H. Rep. No. 1480, Vol. 1, pp. 163-167 (1964).

states in favor of apportionment of unitary business income.[7]

The present case thus raises matters of vital concern to the MTC and the states. They are concerned with the proposition advanced by Exxon that under the Constitution of the United States, it is entitled to invalidate the application of the unitary principles to its vertically integrated petroleum and petroleum related business by "separate accounting." Any such constitutional prohibition would invalidate any reasonable application of the provisions of UDITPA and other state income tax attribution laws which require full apportionment of the unitary income of a unitary trade or business.

They are also concerned with problems associated with the taxation of income from intangible values and

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7 The Recommendations of the Task Force on Foreign Source Income, Committee on Ways & Means, U.S. House of Representatives, March 8, 1977, p. 28 (Rostenkowski Report) concluded:

> . . . [T]here is no significant disagreement that the states must use some type of apportionment formula [as distinguished from making an allocation of income and deductions by separate accounting], since there would be no practical way of determining what income of a company is earned within a state as opposed to being earned without other states [or in foreign countries.] Furthermore, all of the bills introduced in Congress provide for the apportionment of domestic income rather than separate accounting.
>
> See the bills cited in footnote 1 of *U.S. Steel, et al. v. Multistate Tax Commission, et al.*, *supra*, 434 U.S. 452 at 456 as examples.

properties which is not accounted for by the "separate accounting" of "operating income" derived from instate activities.[8]

The states are also concerned with the simplistic approach of Exxon in the record in this cause in dividing its far-flung activities into the neat captions of marketing, exploration and production, and refining. By its "separate accounting" method, Exxon attributes no net profits to a variety of its business activities, such as supply and purchasing and overall management. This simply demonstrates that it is free to attribute profit to any segments of its business which it chooses to and to ignore important aspects of its business as "non-profit" centers.

Exxon here challenges the constitutional validity of the Supreme Court of Wisconsin's decision which simply held, in conformity with the unitary decisions of this Court, that Exxon was conducting a unitary business both within and without Wisconsin and that Wisconsin was entitled to tax a reasonable portion of the income from Exxon's unitary business by application of a reasonable apportionment formula.

This case thus has far-reaching implications for states which impose taxes on or measured by net income on vertically integrated multistate-multinational

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8 In the instant case, Exxon contends that all that Wisconsin is constitutionally entitled to tax is the income of operating properties directly traceable to Wisconsin activities. Exxon here assumes that the difference between the "separate accounting" results and the apportionment results are attributable solely to the differences in the profit levels of marketing as contrasted to marketing plus exploration, production and refining. This is not the case.

businesses. It involves the fundamental question of whether these taxes may be constitutionally levied based on reasonable application of unitary principles. It is for this reason that the MTC and participating states have requested permission to participate in this cause.[9]

COUNTER STATEMENT OF QUESTIONS INVOLVED

We do not accept Exxon's Statement of Questions Involved. We believe that the only question here involved is as follows:

Whether the Supreme Court of Wisconsin interpreted and applied Wisconsin's corporate privilege tax measured by "net income" in a manner in conformity to the due process and commerce clause requirements of the United States Constitution when it rejected Exxon's "separate accounting" *per se* argument and held that Wisconsin could constitutionally measure its corporate privilege tax by a reasonable portion of Exxon's apportionable unitary income, even though it resulted in attributing income to Wisconsin in excess of Exxon's "separate accounting" results.

Subsidiary to this question are the following:

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9 There is yet another dimension to the "separate accounting" versus formulary apportionment issue which is clearly overlooked by the argument of Exxon. Wisconsin has not imposed an income tax on Exxon. The tax in question is a corporate privilege or franchise tax. It is imposed at the beginning of a tax year for the privilege of conducting corporate activities in Wisconsin for the ensuing year. For this privilege, the corporate privilege tax is *measured* by net income for the preceding year as defined under Wisconsin law.

1. Whether Exxon conducted an integrated unitary petroleum business partly within and without Wisconsin for the years in question.

2. If Exxon conducted an integrated unitary petroleum business partly within and without Wisconsin for the years in question, whether the State of Wisconsin conformed to due process limitations on its taxing powers when it measured its corporate privilege tax by that part of Exxon's unitary "net income" attributable to Wisconsin by a well-recognized three factor apportionment formula.

3. Whether the State of Wisconsin violated the due process clause when it measured Exxon's corporate privilege tax by net income apportionable to Wisconsin when the apportionment formula employed by the State of Wisconsin attributed an amount of net income to Wisconsin substantially in excess of the amount of "net income" which would be so attributed to Wisconsin by Exxon's internal "functional separate accounting."

4. If Exxon's "separate accounting" controls to determine what net income of Exxon can constitutionally be attributed to Wisconsin for corporate privilege tax measurement purposes, has Exxon properly "separately accounted" for its Wisconsin income by its accounting for its net income from its primary "separate accounting" profit centers of exploration and production, refining and marketing activities for state tax purposes.

5. Whether the State of Wisconsin could constitutionally include income from property with a fixed situs without the State of Wisconsin in apportionable income when the income from this property constituted a part

of Exxon's income from its integrated unitary petroleum business.[10]

STATEMENT OF THE CASE

A. History of the Proceedings.

Exxon reported its corporate franchise tax to Wisconsin for the years in question (1965-1968) by "separately accounting" for its "marketing" activities in Wisconsin. Upon audit, the Department of Revenue of Wisconsin disallowed the separate accounting method based on the conclusion that Exxon's business activities in Wisconsin were an integral unitary part of its activities both within and without Wisconsin and thus applied what is commonly referred to as the "unitary" method in lieu of Exxon's "separate accounting" method. Exxon appealed from this determination of the Department to the Wisconsin Tax Appeals Commission. In its decision and order, the Appeals Commission made certain findings of fact, which the circuit court set aside as erroneous. (Juris. St. App. 36-65)

Based on these factual findings, which alone demonstrate significant unitary ties between all aspects of Exxon's business operations, the Appeals Commission nevertheless found that the three main functional operating departments of Exxon, exploration and production (e & p), marketing and refining, were not a unitary

10 Since, in applying its apportional formula to Exxon, the Appellee excluded from apportionable income any income resulting from sales of crude oil to third parties at the well head, the Wisconsin Supreme Court did not have to consider whether income from such sales was properly excluded from apportionment as a matter of State Law or as a matter of Constitutional Law.

business. It based this legal conclusion on the finding that there was no economic dependence between Exxon's marketing operations and its e & p and refining functions (Jur. St. App. 69). The Appeals Commission also concluded that the apportionment formula utilized by the Appellee had the effect of imposing a tax on Exxon's e & p and refining net income (Jur. St. App. 71).

The Circuit Court found that there was economic dependence between Exxon's e & p, refining and marketing functions and that therefore the Appeals Commission erred as a matter of law in not so finding (Jur. St. App. 54). The Circuit Court then concluded:

> "That the business of Humble during the years in question considered as a whole both within and without Wisconsin constituted a unitary business . . .." (Jur. St. App. 54-55)

On appeal, the Supreme Court of Wisconsin held that Exxon's Wisconsin operations ". . . constituted an integral part of a unitary business subject to statutory apportionment . . . ." (Jur. St. App. 2)[11]

11 In so doing, it applied the definition of the term "unitary" relied on by the trial court and applied in *Interstate Finance Corp. v. Department of Taxation*, 28 Wis. 2d 262, 269, 137 N.W.2d 38 (965) which definition it found was in turn borrowed from the text authority Altman and Keesling, *Allocation of Income in State Taxation*, 2 ed., at p. 101. (Jur. St. App. p. 9) It then quoted that definition as being " '. . . the essential test is whether or not the operation of the portion of the business within the state is dependent upon or contributory to the operation of the business outside of the state. If there is such a relationship, the business is unitary.' " (Jur. St. App. 9) As shown *infra*, this is generally accepted judicial definition of a unitary business.

The Supreme Court of Wisconsin, in finding that the marketing function contributed to the e & p and refining functions (Jur. St. App. 12) quoted as follows from the testimony of Mr. Luper, an Exxon Executive Vice President:

> ". . . [I]n any industry which is highly capital intensive, such as the petroleum industry, the fixed operating costs are highly relative to total operating costs, and for this reason the profitability of such an industry is very sensitive and directly related to the full utilization of the capacity of the facilities.
>
> "So, in the case of the petroleum industry . . . where you have high capital investments in refineries, the existence of an assured supply of raw materials and crude is important [the exploration and production function] and the assured and stable outlet for products [the marketing function] is important and therefore when there are--when these segments are under a single corporate entity, it provides for some assurance that the risk of disruptions in refining operations are minimized due to supply and demand imbalances that may occur from time to time." (Jur. St. App. 14)

The Wisconsin Supreme Court then quoted at

length from a parallel case, *Humble Oil & Refining Co. v. Oregon Dept. of Rev.* 4 OTR 284 (1971), wherein the unitary nature of Humble's business of marketing, e & p, and refining was reviewed at length (Jur. St. App. 17-19, App. Br. 17-30).

Based on this Court's analysis in *Butler Bros. v. McColgan*, 315 U.S. 501 (1942), of the relationship of "separate accounting" to the apportionment of the unitary income of a unitary business, the Wisconsin Supreme Court concluded that the fact that the separate acounting of marketing operations in Wisconsin resulted in a loss for the disputed years is immaterial (Jur. St. App. 19-20).

As an adjunct to the "separate accounting" versus "unitary" issue, the Courts below considered an issue pertaining to the exclusion from apportionable income so-called "situs income" by reference to § 71.01(1) of Wisconsin's statutes. The Appellee had excluded production income attributed to third-party sales but had included production income attributed to the e & p function by Exxon's "separate accounting" for interfunctional transfers in apportionable income. Thus, production income from third-party sales is not at issue here. The only income at issue here is the production income used in the business.

In addition to providing for apportionment, this section states that income derived from specifically designated real or tangible personal property such as income from the operation of mines is taxable at the situs of the property, the Wisconsin statute interpreted the situs provision of § 71.07(1) of Wisconsin statutes (which also provides for apportionment of income derived from both in-state and out-of-state business), as pertaining to

taxation of income or loss from business not requiring apportionment. It then concluded that the apportionment of "situs income" may be required by the appellee to the extent that it is a part of the unitary income of a unitary business. (Jur. St. App. 22)

Exxon here asks this Court to reverse the foregoing holding of the Wisconsin Supreme Court on constitutional due process and commerce clause grounds.

B. Statement and Analysis of Facts.

While it is not the function of this Court to review an evidentiary record and the factual findings and conclusions of courts below, we believe that reference to the facts here are of extreme importance in resolving the constitutional issues posed by this appeal. We are here more concerned with the nature and configuration of the factual conclusions relied upon by Exxon and their general impact rather than with a recitation of facts as such.

At the hearing before the Appeals Commission, Exxon produced a substantial volume of evidence to prove that its operations were principally that of e & p, refining and marketing functions, and that these functions were not interdependent and that they generated their own profits which could be separately accounted for. It did not contend, however, that it was not a vertically integrated oil company or that all of its operations were not subject to strong centralized management, financing and control or that its operating departments did not have a substantial exchange of goods and services as between themselves and as between various levels of its centralized management. In fact, it produced evidence which establishes the existence of all the unitary ties between the various segments of its business

activities which have been relied upon by the courts to define the contours of a unitary business.

Exxon did not contend that, *as a matter of fact*, there was not any interdependence of operations between its centralized management and financing and between its e & p, refining and marketing functions and between each of these functions. For example, it did not contend that its crude oil from its production facilities did not flow to its refining facilities and from its refining facilities to its marketing facilities as an integrated part of its transportation and other corporate functions. In short, it did not argue with the factual pattern found to exist by the Oregon Tax Court in *Humble Oil & Refining Co. v. Oregon Dept. of Rev., supra.*

Neither did Exxon contend that its integrated activities as a single corporate entity, conducting a vertically integrated petroleum business, did not result in overall economy to all of its operating departments. Exxon thus premises its constitutional arguments on the fact that, irrespective of the unitary and integrated nature of its operations, including that of its marketing, refining and production, it can "separately account" for its profits from its marketing operations as distinguished from its profits from its refining operations and its exploration and production operations by generally accepted accounting principles. Furthermore, it made no attempt to establish the validity of any "separate accounting" of its expenses related to any of its functions or for its "net income" or losses of its other functions and activities.

The foregoing is supported by an analysis of the evidence in this cause.

Exxon's first witness, Oral L. Luper, testified, as an

expert, to the overall responsibilities of three levels of top management which consisted of *Corporate Management, Coordination and Services Management* and *Operations Management* (Exh. 20, A755; A187-189). The operating departments (e & p, refining, marketing, etc.) were subject to these three levels of top management control (Exh. 20, A755).

Corporate Management comprised the top executive management. It consisted of the Board of Directors, Executive Committee, President, Chairman of the Board, Chief Executive Officer, and Directors-in-Charge. The directors, in addition to being full-time members of the Board of Directors, were the executive officers of Exxon, having general responsibilities for specified operating departments for the *Coordination and Services Management* function (A755).

The *Coordination and Services Management* comprised the second tier of Management (A188). It was composed of corporate staff departments with the responsibility of providing the overall specialized corporate services that were needed by Exxon (A188-189). This included the departments of Corporate Planning, Secretary's, Supply, Treasury, Comptroller, Tax, Law, Public Relations, Employee Relations, General Services, Medical and Aviation (Exh. A755; A188-A192).

Corporate Planning was responsible for assisting and developing the overall company strategies. It advised the Board as to how to maximize the effectiveness of the overall operations of Exxon (A189).

The *Secretary's department*, among other things, was responsible for executive compensation, executive development and training, and general advice in corporate affairs (A189).

The *Treasury department* was responsible for all of the financial resources, the development of financial policy and procedures, and the maintenance of banking relations. This department also developed plans for the appropriate financing of Exxon's activities and provided an analysis of the financial aspects of any proposed investments (A190).

The *Comptroller's department* was responsible for the overall maintenance of the accounting system, procedures and plans related to capital budgeting, and for financial reporting and financial forecasting (A190). It was also in charge of the computer program and internal audit and control (A190).

The *Supply department* (a non-profit center) coordinated the demand for and the movement of products in regard to the functional departments of e & p, refining, marketing and transportation (A252). It executed contracts for the purchase of such things as tires, batteries and accessories sold by the marketing department (A257-A258) and handled exchange agreements (A245, A257). The exchange agreement for gasoline sold in Wisconsin for the years in question was negotiated in the Houston office by the Supply department (A279). The Supply department would arrange for crude oil to be delivered to the refineries (A281) and the movement of gasoline to marketing operations which came primarily from Exxon's refineries and exchanges (A233).

Mr. John J. Jeager, as manager of crude oil of the Supply department, had the principal responsibility:

> . . . to manage the crude oil supplies of the company in the United

> States. This broadly covered the disposition of all the company's produced crude and responsibility to say that the company's refineries had adequate supplies of the proper types of crude to meet their requirements . . . . (A296-A297)

In further testifying as to the functions of Exxon's Supply department, he stated:

> Well, in addition to the movement of crude, that is the buy and sell, the transportation activities, we had some planning responsibilities with regard to expansion of refineries, what future supplies might be, and we had responsibility to appraise the market to determine what proper prices should be for the crude oil, and it was my group that would develop pricing strategies and pricing-actual pricing changes that would be made, and recommend such changes to the board of directors. (A297)

Operations Management was responsible for directing the operating activities of the individual functional segments of Appellant (A193) which consisted of e & p, refining, marketing, marine, coal and shale oil, minerals, and land management (Exh. 20, A755, A193-A194).

The rest (fourth level) of Appellant's management structure was at the operating department level (Exh.

20, A755; A193). Top executive management adopted a "functional profitability independence" policy for these individual operating departments as the most effective management tool to measure the performance of the departments and to improve their operations (A193).

The sources of capital for investment in Wisconsin property came from the corporate treasury (A259). Top level promotions and overall retirement policies and salary levels of operating department personnel were not determined at the operating department level; but they were controlled by corporate staff departments (A263-A264). Furthermore, the corporate staff was involved in labor relations (A265). The budget of each operating department was approved at the overall top management levels (A265). It was the policy to transfer employees between departments as a matter of routine procedure (A269). Mr. Luper further testified that the term "vertically integrated petroleum company" is ". . . normally applied to a petroleum company that is involved in all the major operating functions, principal operating segments of the business." (A272)

The three principal operating departments (e & p, refining and marketing) were treated as separate profit centers (A193-A197). There was in existence a system of providing values for the transfer of raw materials and products interfunctionally between departments to provide a basis for determining the functional profit or loss, for each of these major operating segments (A204). The objective of the system was to provide a basis of valuing transfers which would *approximate* the same results *as if* one separate independent company had *negotiated with* another separate independent company

(A207). Each functional department was also recognized as an investment center (A204). In regard thereto, Mr. Luper testified:

> I might add here that the attractiveness of an investment in refineries is directly related to the adequacy and stability of the source of raw materials and crude. The attractiveness of this refinery investment is also directly related to the adequacy and assured outlet for the products, and, this, of course, means that where assured and stable supplies of raw materials and assured outlets for products exist, the refining investments become attractive . . . . (A204-A205)

> By the same token, the marketing department is responsible--is interested in the type and quality of products that are received from the refining department so this just means, I think, that when you have the exploration and production activities and the assured market outlets, there is less opportunity for disruption due to fluctuation and the demand and supply balances. (A205)

For interfunctional transfer purposes, it was company policy that the transfer of values for products and raw materials should be based upon a competitive wholesale market price (A206). However, Mr. Luper testified:

> For some products, of course, there is no readily available quoted wholesale market value or price, and in these cases the representatives of our marketing department and our refining department with both of their knowledge of the market, knowledge of the products, *negotiate* with each other on an arm's length basis in an adversary position to try to *negotiate the appropriate transfer value* to the best of their ability, market oriented. (A206) (emphasis added)

He also noted that there is greater precision in interfunctional pricing between exploration and production functions than between refining and the marketing functions (A208).

However, according to Mr. Luper, all of these interfunctional transfer prices are entirely adequate for accounting, regulatory and tax purposes (A208-A209).

In answer to the question of why separate operating departments of Exxon were organized under one corporate entity, Mr. Luper testified:

> [I]n any industry which is highly capitol intensive, such as the petroleum industry, the fixed operating costs are highly relative to total operating costs, and for this reason the profitability of such an industry is very sensitive and directly related to the full utilization of the capacity of the facilities.

> So, in the case of the petroleum industry it is--where you have high capitol investments in refineries, *the existence of an assured supply of raw materials and crude is important and the assured and stable outlet for products is important, and therefore . . . when these segments are under a single corporate entity*, it provides for some assurance that the risk of disruptions in refining operations are minimized due to supply and demand imbalances that may occur from time to time. (A224-A225; emphasis added)

In regard to how a combination of the separate functional departments of e & p, refining and marketing under one corporate entity affect profit stabilities, Mr. Luper testified:

> Here again the placing individual segments under one corporate entity does provide greater profit stability for the reason that the factors . . . which may effect one department may be offset by the factors existing in another department. And this produces a greater opportunity for profit stability. (A225)
>
> . . . . .
>
> The combination of the individual segments under one corporate entity does reduce the impact

> of risk. The operations of the exploration and production departments have a very high degree of risk, and much higher than other types of industrial activity. So when this type of operation is combined under an entity with other operations with less risk, it provides a diversification and gives some protection against the risk hazard. (A225)

Mr. Luper was asked whether any other reasons came to mind for combining the separate operating functions in one corporate entity (A225). He answered as follows:

> Yes, yes. Again [by] putting the individual segments under one corporate entity provides an opportunity to provide a corporate staff, corporate staff services which I described earlier in my testimony that enable the entities to attract high quality of staff employees. The cost and economies are obtained because the more efficient and effective use of these staff groups when they are made available on a corporate-wide basis. (A226)

On cross-examination, Mr. Luper testified:

> I testified this morning that the attractiveness of refinery investments are directly related to a stable and

> assured supply of crude oil and raw materials. (A281) . . . .
>
> [A]s I have said before, the existence of a stable and assured market outlet is directly related to the refinery investment. (A239-A240)

Whether the supply department would dispose of Exxon's crude production to outsiders depended upon the economies to Exxon which were related to the location of its refineries, crude oil and the availability of transportation facilities for movement of the crude to Exxon's refineries (A299).

The competitive price for crude which was utilized by Exxon for accounting for e & p function profits was related to "posted-field prices" of the purchasers but many times there is more than one posting because there is more than one purchasing company (A300-A301). In regard to the particular posted field prices in any particular field, Mr. Jeager testified:

> Yes, as I said awhile ago, a company who wants to buy crude, they, of course, want to buy it at the lowest price so they--in order to keep the price down. On the other hand, if there is competition in the buying, that tends to drive the price up, but there is an upper limit to what the company can pay because of the cost of moving to the refinery, manufacturing the product, and then competition in the product market.

> Now all these factors get worked into what . . ., the competitive prices will be in any particular field. (A301)

During the years in question, Exxon had surplus refining capacity and refined all of its products (A317). This resulted from the fact that there was an inadequate market for Exxon's refined products and not because of any shortage of crude (A319-A320). The gasoline marketed by Exxon came primarily from its own refineries or from exchange agreements (A233).

Because of the depletion deduction, it was to the tax advantage of Exxon to maximize its revenues from crude oil and gas production (A277). It attributed any profit from the supply department activities pertaining to disposition of crude oil to the e & p department (A313-A314).

Mr. Campbell, a staff commerce advisor in the supply department of Exxon, who was involved in the exchange of products by Exxon east of the Rocky Mountains, also testified on behalf of Exxon (A340). His work included exchanges of finished products, exchanges of crude for the refineries, the setting up of exchanges (long-term and spot arrangements) to cover emergencies (A340). He testified that the supply department was also involved in the direct purchase or sale of products for Exxon (A340). It utilized the use of the "Platt's oil gram" for pricing of various petroleum products which were transferred internally (A340-A345). The products were sold between the refining and the market department based on a formula tied to "Platt's oil gram."

. . . [I]t was a discounted formula based on the history we had of our third-party sales to Standard Oil of Kentucky. The transfer price to marketing from refinery was on a *negotiated discount* from the Platt's oil gram. The discount factor was established around 1961 or possibly 1962 and was a result of *negotiations* between marketing and refining based on the history of the Standard Oil of Kentucky contract.

> These prices are a day-to-day type price and historically if someone wanted to make a long-term contract or a large contract, they could effectively negotiate a discount off of this price, and that is how we established transfer price from marketing to refining. (A343) (emphasis added).

The proprietary products of Exxon were not covered in any posting in Platt's oil gram. However, the base stock covered by the Platt's oil gram was used as a starting point in the negotiations between the refining function and marketing function of Exxon (A347). The interfunctional transfers of products between Exxon's operating departments involved price build-up and negotiation factors (A347-A348).

According to Exxon's witnesses, there is nothing unique in the oil industry in Exxon's functional accounting approach for the dividing of profits between e & p, refining and marketing. As stated by Mr. Wehner, an expert accounting witness:

> It has been my experience that oil companies use the functional profitability independence for measuring the performance of their various operations. They measure their performance of the e & p function by applying posted field prices and fiske-type formulas to determine the values of the products and to measure the profitability and success and operations of the personnel, and by the respect of the other functions, the refining function, they measure the performance of that operation by having a net income determination by that particular function and carried over into marketing and each of the other functions, so that they use this for a number of purposes, probably the principal of which is to measure the performance of their personnel and their investments with respect to those functional operations. (A436-A437)

Mr. Wehner also testified that accounting for tax purposes is quite a different matter than accounting for financial and management purposes (A455). Furthermore, he was not qualified to answer the question of the relevance of functional accounting to attribution of income by an apportionment method (A455). He further indicated that utilization of total company sales as compared with total company net income represents one means of testing the reasonableness of the application of an apportionment formula (A455). Mr. Wehner described the unitary business as a

series of business operations which are so related that they are *completely dependent and contributory* to each other in the final business operation (A456; A458).

Exxon next called Professor Ezra Solomon as an expert economic witness to testify as to what constitutes an integrated unitary business. He defined a unitary business as a ". . . minimum unit which provides economic viability." (A493; A512) He further stated that in his opinion if any component of a business is not *vital or necessary to another component* of a business, these components of the business are not unitary (A494-A502). Mr. Solomon also testified that the very fact that independent refineries, producers and marketers exist on a fairly large scale in the oil industry suggests that Exxon's e & p function, refining function and marketing function constitute non-unitary businesses (A507). Mr. Solomon did indicate that these functions would be better off profit-wise if combined in an integrated company (A509; A512). He would not consider centralized management and control important (A497-A498). He testified that the accounting for profits for tax purposes and the accounting for profits for managerial and financial purposes do not lead to the same accounting result (A510-A511).

From the foregoing, it is evident that Exxon's witnesses were generally testifying as to the integrity of Exxon's internal functional accounting system for the attribution of some of its overall gross income, namely, that relating to the e & p function, the refining function and the marketing function. The testimony further indicates that this accounting was based upon negotiations between various operating departments as related to "posted field prices" for crude oil, "Platt's oil gram" for

selected products of the refineries and the Fiske formula for the development of contract prices for natural gas.

The use of "Platt's oil gram" and the "posted field price" to determine the transfer value of products from one function to another is admittedly the result of marketing conditions. However, there is nothing in the record to indicate how the location of Exxon's refineries and its market outlets affect either of these prices as pertains to Exxon's crude oil production, its refinery operations and its products. Also, if Exxon had no marketing and thus dumped its crude oil and refined products on the market, there is no evidence of the impact of this on the assumed market conditions on which it based its interfunctional transfer pricing.

One very significant aspect of the Exxon's business is the transfer of products and crude oil by exchange agreements with other oil companies. These transfers obviously result from negotiated contractual arrangements. Yet, there is no indication how such agreements impact the various functional operations of the Exxon's business. The record indicates that the most significant aspect of Exxon's business for the years in question was the need to find a market for its products. This follows from the fact that there was a surplus of crude oil on the market and a surplus of refining capacity at Appellant's refineries for the years in question. Obviously, under such circumstances, Exxon's marketing activities had a considerable impact on all operational functions of the company.

Thus, the record leaves many uncertainties in regard to the reliability of Exxon's functional accounting for the e & p, refining and marketing functions. Obviously, this accounting is dependent upon a great many

of assumptions, including assumed negotiations, contracts, and prices assumed with third parties pertaining to Exxon's operations both within and without the three principle functional departments. While there is admittedly substantial economies in all of Exxon's functions due to the integrated nature of its operations, there is no indication in the record as to how such economies are to be assigned on a functional accounting basis.

While there is testimony that all of Exxon's operating departments are dependent upon contributions of integrated centralized management, financing, planning and control, including acquisitions and dispositions of Exxon's property between its various departments, the record is void of any system utilized by Exxon, from an accounting viewpoint or otherwise, for the attribution of the expenses of centralized management and control to its operating departments.

While Exxon's e & p, refining and marketing functions were subject to strong centralized management and control and to three levels of supervision within the organizational structure of Exxon, there is no explanation in the record as to why Exxon's profits were substantially all attributed to these functions rather than to other functional operations. For example, why was the supply department function treated as a "non-profit" center? Why should not some of the profits of Exxon be attributed to the very important and integrated activities of the supply department?

An examination of Exxon's federal income tax returns (page 1 of federal form 1120) set forth as part of Exhibit 28 (A761-A765) indicates that over one-third of its gross receipts for the years in question (1965-1968) are attributable to centralized administration. This

amounts to approximately 6.7 to 11.1 times Exxon's federal taxable income for the years 1965-1968. The record is silent as to how the costs of these centralized administrative functions of the three levels of top management were attributable to the operating departments. Obviously, the reliability of the method of apportionment of these administrative costs is critical to any "separate accounting." Furthermore, the fact that they must be apportioned indicates the need for ascertaining the net income of the operating departments by apportionment rather than "separate accounting."

The "separate accounting" evidence and analysis of Exxon only touches selected aspects of its total business operations. For example, transportation undoubtedly is a major component of Exxon's business, as well as supply. It has a direct bearing on the profit levels of the e & p, refining and marketing functions. Yet the record is silent as to this significant aspect of Exxon's business. Such losses would substantially reduce "net income."

In short, to arrive at its division of profits between its operating functions of e & p, refining and marketing, Exxon has relied on certain aspects of its internal accounting and certain aspects of the integrated operations it conducted for the years in question. It has completely ignored a vast amount of its other business operations and accounting procedures. All of these accounting results in turn are related to theoretical assumed market conditions which would not exist if it made the third-party transfers which it assumed took place by the functional allocation of its net income.

What the market might be for Exxon's crude oil and refined products if it had not integrated these functions with other functions of its business, including

transportation and marketing, is not known. It is self-evident that the sale of Exxon's crude oil in the open market and its refined products in the open market for the years in question would have had a significant impact on those markets. Thus, "Platt's oil gram" and "posted field price" standards as used by Exxon in this case are also theoretical. Exxon's internal accounting, apart from the fact of its integrated operations as a unitary business, is highly speculative and misleading.

The foregoing limitations on Exxon's "separate accounting" approach is substantiated by a letter of December 16, 1975 from A.L. Monroe, Exxon Comptroller to the late Senator Philip A. Hart in connection with the hearings of his subcommittee on anti-trust and monopolies concerning congressional divestiture legislation pertaining to the petroleum industry. On December 5, 1976, Senator Hart wrote Exxon and several other major oil companies requesting their profit and loss statements and balance sheets, audited or unaudited, covering separately production, transportation, refining, lease and marketing. On December 16, 1975, A.L. Monroe, Exxon's Comptroller, replied as follows to this inquiry of Senator Hart:

> We have prepared schedules showing the condensed profit and loss statement for each of the four major segments of the company's operations:
>
> U.S. upstream.
>
> U.S. downstream.
>
> Foreign upstream.

> Foreign downstream.
>
> This segregation of earnings is consistent with data that we have supplied to other congressional committees. The operations contained in each of the above segments are indicated on the individual schedules. *Exxon's financial records are maintained on a corporate basis rather than a functional or segment basis.* Since there are market prices for most crude oils, it is possible to divide earnings on an upstream/downstream basis. *However, a further division of earnings is not meaningful due to the difficulties related to transfer prices and the allocation of costs.* (The Congressional Record--Senate, March 26, 1976, p. S 4395)

As further indicated by Senator Hart:

> On December 5, I wrote to the presidents of several major oil companies requesting certain data, including an "item 5" which called for "profit and loss statements and balance sheets, audited or unaudited, covering separately production, transportation, refineries, and marketing."

After further correspondence, Exxon's comptroller, Mr. A. L. Monroe, replied and stated unequivocally:

> As we indicated in our first response and as further discussed with a member of your staff, Exxon Corporation's financial records are not maintained on a functional or segment basis similar to those categories set forth in your item 5.

Mr. Monroe's letter went on to explain:

> As for further statements of revenue and expenditures data directly attributable to each of the above-mentioned groupings [crude production, refining, marketing and transportation], our earlier response, together with the above clarifications, indicate that our corporate records are not maintained in that manner, nor do our independent public accountants prepare such allocations. As we *indicated in our December 16 response and in responses to other Congressional Committees*, to the FTC's Line of Business and Croporate (sic) Patterns reports, and to the FASB's proposal for segment reporting, *the petroleum business is unitary in nature*. The most meaningful segmentation of our operations is the "upstream"/"downstream" segmentation previously furnished for the years 1972-74. Further *breakdowns require many allocations and asumptions*, which could lead

> to erroneous comparisons of data between various companies and hence erroneous conclusions.
>
> Similar responses were received from other major oil companies from whom this data also was requested. (Cong. Record--Senate, 94th Cong., 2nd Sess., Vol. 122, No. 43, March 25, 1976, p. 1; emphasis added)

Based on the foregoing, which is substantiated by the gaps in the record in this cause, Exxon's evidence concerning "separate accounting" of its e & p function, refining function and marketing function must be viewed as fragmentary and incomplete.[12]

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12 The nature of the integration of Exxon's operations as a unitary business and the advantages of the same are commented as follows by a prepared statement of Exxon Co., USA., in the hearings before the subcommittee on anti-trust and monopoly of the Committee on the Judiciary United States Senate, 94th Congress. First Session, on S2387 and related bills, Vertical Integration Part I, hearings September 23-26, October 29-31, November 12, and 19, 1975:

> **II. THE EFFICIENCIES OF VERTICAL INTEGRATION**
>
> Vertical integration is an efficient form of industrial organization which is commonly used by a great number of American companies, both large and small, in order to better serve the consumer at lower costs. In addition to petroleum, some other industries which have integrated companies include autos, food, newspapers, steel, tobacco, beer, machinery, communications, papers, nonferrous metals, chemicals, rubber products, textiles, and stone, glass, and clay.
>
> For instance, many newspapers and publishers have integrated backward into forest product companies and paper manufacturing companies to assure an adequate supply of newsprint. Many newspapers also have company-owned transportation equipment to insure efficient distribution of

(footnote 12 continued on next page)

SUMMARY OF ARGUMENT

There can be no question that for the years in question Exxon conducted an integrated unitary petroleum business, including its operating departments of e & p, refining and marketing and that this business was

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their product. Moreover, integration also takes the form of syndication whereby certain papers put feature writers under contract and distribute the stories exclusively to syndicate members.

Just as in the petroleum industry and the newspaper industry, vertical integration allows the companies in many industries to deal with uncertainty in a company's economic environment by providing for reliability in terms of quantity of supply, product quality, price, and service. Vertical integration also allows better coordination of expectations and activities between stages of production with a high degree of interdependency and, therefore, results in a reduction of required inventories and working capital. Moreover, these aspects of vertical integration improve a company's access to capital markets--not only in terms of a lower cost of capital because of lower risk, but also because of its increased ability to communicate to investors the entire interdependent investment picture.

Vertical integration also effects savings in transactions and communications costs in terms of reductions in operating and support staffs, and the concomitant elimination or reduction in reports and data handling, reduced costs of negotiations, reduced need for settlement of disputes, and better communication because of common training, experience, linguistics code, and community of interests among employees. All of these advantages of vertical integration obviously add up to cost savings to the consumer.

Neither long- nor short-term contracts are an adequate substitute for vertical integration in this adaptive, sequential decision-making process. Efficient supply from a petroleum company, as with many companies in other integrated industries, requires large and expensive investment in special-purpose, long-life equipment. Thus, optional investment considerations favor the award of long-term contracts to

(footnote 12 continued on next page)

conducted in part in the State of Wisconsin. The fundamental issue in this cause, then, is whether on the record and in the context of a tax on or measured by "net

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permit the supplier to amortize his investment with confidence.

Although long-term contracts can result in an industrial structure very similar to that existing under vertical integration, long-term contracts are not adequate substitutes for vertical integration. Contingent supply relations must be exhaustively stipulated in long-term contracts to prevent conflict over contract ambiguities. Unfortunately, this is often precluded by the bounds of rationality and the inability to foresee the future. Those stipulations which are specified are often costly in themselves. Suppliers demand a substantial premium when they commit their resources to a particular buyer under specified conditions for a long period of time. Moreover, costs multiply when changing technology and market circumstances force renegotiation. Needed amendments are costly--not only in terms of time and money, but also in the distortions in the decision-making processes they invariably create. Such distortions can include the total cancellation of plans because of the inability of a party to honor a long-term contract. Many industries have experienced severe hardships when suppliers have been unable to deliver vital raw materials.

III. VERTICAL INTEGRATION IN THE PETROLEUM INDUSTRY

Like other industries, various segments of the petroleum industry have found it more efficient to integrate on a forward and backward basis into other segments . . .

Vertical integration is a logical and effective structure for the petroleum industry.

The petroleum industry is characterized by large capital investments and complex operations, both physically and in the business sense. Vertical integration has been the logical and natural outgrowth of firms seeking to efficiently utilize capital intensive facilities to smoothly and effectively conduct their operations so they can deliver products to the consumer in a timely and economic manner. These operations include a multitude of discrete physical and commercial transactions including gravity, magnetics, and seismic

(footnote 12 continued on next page)

income," Exxon's "separate accounting" is the due process constitutional standard to determine the validity of an otherwise reasonable apportionment of the unitary

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(footnote 12 continued)

surveys; geological and geophysical studies; lease purchases; exploratory and development drilling; construction and installation of producing facilities; production, gathering and transportation of crude and natural gas, and the construction of the facilities to do so; design, construction, and operation of gas processing facilities and refineries; storage of crude and products; sale of crude not compatible with processing facilities and the purchase of substitutes and supplemental volumes; design of product quality to customer specifications or requirements; product quality control; packaging and bulk transportation of products; distribution to retail sales points; and, finally, consumer sales with the associated billing and collection processes. Each of these more than twenty-five discrete activities is in itself surrounded by significant planning and involves multiple decision-making steps. Vertical integration is merely the interrelating of these processes through a unified management organization and system. The efficiency that can result is obvious. The beneficiary is the consumer.

As suggested earlier, the complexity of modern petroleum operations requires a close and continuing functional interaction on scheduling and control. The potential value for this close coordination can best be appreciated by examining the operations of a large complex operation such as Exxon USA. Each day in 1974 Exxon produced on average 700 MB/D of crude and condensate; purchased 113 MB/D from royalty owners, purchased 737 MB/D from other domestic producers, and imported 257 MB/D from foreign sources; and in turn, sold 780 MB/D to other domestic users. Our domestic production occurs at over 10,000 individual wells scattered through 23 states in the U.S. Imports are received in the Gulf of Mexico and on the East and West Coasts.

After production, coordination must be arranged for the following materials, processes, products, and facilities:

(footnote 12 continued on next page)

income of a vertically integrated unitary trade or business. This issue was squarely raised and disposed of by this Court in *Butler Bros. v. McColgan*, 315 U.S. 501 (1942). This Court there held that "separate accounting" was totally irrelevant in determining the constitutionality of an otherwise valid apportionment formula when applied to the net income of a unitary business. Furthermore, disposition of the "separate accounting" issue in *Butler Bros.* is totally consistent with and is supported by all of the apportionment decisions of this Court whether in the context of an *ad valorem* property tax *(Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194 (1896), rehearing 166 U.S. 185 (1897)); or a franchise "net worth" tax *(Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911); *Ford Motor Co. v. Beauchamp*, 308 U.S. 313 (1939)); or a net income tax *(Bass, Ratcliff & Gretton, Ltd. v. New York Tax Commission*, 266 U.S. 271 (1924); *Maxwell v. Kent-Coffey Mfg. Co.*, 204 N.C. 265, 168 S.E. 397 (1933), aff'd 291 U.S. 642 (1934); *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959); *National Leather Co. v. Massachusetts*, 277 U.S. 413 (1927); *Underwood Typewriter Co. v. Chamberlain*, 245 U.S. 111 (1920); *Hans Rees' Sons, Inc. v. North Carolina*, 283

(footnote 12 continued)

Number of refineries/plants	7
Number of processing units	184
Number of different types of processes	49
Number of different crudes used	100
Grades of petroleum products manufactured	1,300
Bulk plants	921
Number of marketing terminals	102
Number of retail outlets	24,600

U.S. 123 (1931); and *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978)). All of these decisions, and those that follow their holdings, support the proposition that all of the income or values of a unitary business carried on in part within a taxing state are constitutionally subject to a reasonable rule of apportionment, irrespective of "separate accounting" results.

Contrary to Exxon's argument, neither *Hans Rees'*, *supra*, nor *Moorman*, *supra*, support the proposition that "separate accounting" as reflected on the books and records of a taxpayer controls constitutional consequences for the attribution of net income for state taxes on or measured by "net income." In many of the referred-to cases, the taxpayer sought to rely on separate accounting. This was true in *Bass, Ratcliff & Gretton* and the *Underwood* income tax cases. It was equally true in the net worth cases of *Flint v. Stone Tracy Co.* and *Ford Motor Co. v. Beauchamp* and the *ad valorem* property tax case of *Adams Express Co., supra*. In fact, as a general proposition, income attribution disputes between taxpayers and state taxing authorities have generally centered around the taxpayer's efforts to invalidate apportionment results by "separate accounting."[13] These efforts have been uniformly rejected by the courts.

Undoubtedly, the courts have uniformly rejected "separate accounting" as either the statutory or constitutional standard for the attribution of the net income of an integrated unitary business because "separate accounting" does not represent any reliable objective standard for the attribution of income. This is amply demonstrated by the record in this cause. Admittedly, the "separate accounting" results, which Exxon contends are controlling here, are the product of Exxon's internal accounting policies. However, these policies are based upon hypothetical market conditions and hypothetical transactions with unrelated third parties. In addition, there are no objective standards by which to test the validity of Exxon's "separate accounting" for its net income. Exxon is here contending for a self-determination of its corporate tax liability by arguing that its "separate accounting" controls for due process of law purposes.

13 Essentially, Exxon and its amicus curiae would embroil the states in the complex problems pertaining to the implementation of "arms' length" standards to determine the extent of the states' taxing powers within the purview of the due process clause of the United States Constitution. A comparison of application of the "arms' length" standard as contrasted to the unitary standard and the complexity of the arms' length standard is discussed at length in a Note, "Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code," 89 Harv. L. Rev. 1202 (1976).

The due process clause of the United States Constitution has never been so construed by this Court. As this Court indicated in *Moorman Mfg. Co. v. Bair, supra*, and cases of like import, the due process clause only requires that a state tax be related to the activities carried on by a taxpayer within the state. There must only be a sufficient instate presence (1) to satisfy "nexus" requirements and (2) to establish a relationship of the tax to the instate taxable activities of the taxpayer. These dual requirements are satisfied for state taxes on or measured by net income if a reasonable apportionment formula is applied to the total net income of a unitary trade or business carried on in part within the taxing state and the taxpayer has not proved that extraterritorial values are taxed.

The fact that Exxon by "separate accounting" would attribute none of its "separately accounted" for net income from its e & p and refining departments to Wisconsin is totally irrelevant to resolution of the due

process question if the operations of its e & p and refining departments constitute a part of its integrated unitary business of marketing which it carried on in part in Wisconsin for the years in question and reasonable apportionment rules are applied by Wisconsin. In other words, the due process connection is established and the due process requirements fulfilled by resolution of the question of whether or not Exxon's marketing operations in Wisconsin are integrated with and constitute a part of Exxon's unitary business operations of refining and e & p.

In any event, why "separate accounting" should not control for due process purposes is amply demonstrated by the record in this cause. Exxon's "separate accounting" suffers from the inherent defect that no one knows what Exxon's profits would have been for the years in question *but for* its Wisconsin marketing activity or but for Exxon's marketing activities everywhere. Of controlling significance here is the fact that Exxon made no profits whatsoever until it sold its products through its marketing operations. Exxon realized profits from its refining and e & p departments only as a result of its marketing operations.

In determining the "net income" of the various departments of Exxon, Exxon's "separate accounting" is a product only of theoretical transactions with unrelated third parties. It is nothing more nor less than the result of the management judgments of Exxon's executives in conformity with generally accepted accounting and economic practices of the oil industry. Such management judgments should not control the due process limitations on state's taxing power.

In the instant case, a *slight error* or *shift* in Exxon's "separate accounting" for "net income" between its vari-

ous complex and interrelated activities and functions could completely eliminate any profit for the years in question which would be attributable to Exxon's marketing operations by its "separate accounting." Furthermore, a *slight shift* in Exxon's "separate accounting" in favor of its marketing or centralized operations could completely eliminate the controversy in this appeal which is based solely on a differential between e & p and marketing "separate accounting." Furthermore, Exxon made no effort on the record to justify its accounting for its expenses as distinguished from its gross income from its e & p, refining and marketing activities.

The controlling fact here is that there is no objective standard to test the validity of Exxon's "separate accounting" and that such "separate accounting" results are subject to change at the sole discretion of Exxon. As a pragmatic proposition, then, Exxon's "separate accounting" argument would require the states to accept, as a due process constitutional standard, any taxpayer's internal accounting for the distribution of "net income." The only alternative would be for the states to attempt a transaction by transaction analysis of a taxpayer's business activities and test the validity of such an analysis by illusive and uncertain accounting concepts and practices by reference to hypothetical third-party transactions. In the instant case, it may be asked, what reasonable objective criteria was available to Wisconsin to refute the "separate accounting" of Exxon which was justified by Exxon's expert witnesses? Furthermore, if such objective criteria in fact existed, was it administratively feasible for Wisconsin to expend the thousands of audit hours necessary to apply such criteria to all of Exxon's internal departmental transactions? The answer is "no" for the simple reason that the direct cost to both Wisconsin and Exxon in the application of such audit practices would

far exceed the amount of tax dollars in controversy.

However, no such objective standards exist to test the validity of Exxon's "separate accounting." The fact that Exxon's "separate accounting" is speculative is proven by the necessity of Exxon's reliance on expert testimony to prove its case. This testimony is necessary because there is no other standard of proof available. Yet, in denouncing Wisconsin's audit results as arbitrary and unconstitutional, Exxon argues that "On adverse examination the auditor for the Wisconsin Department of Revenue . . . admitted he could not really challenge the separate accounting results. (A627-A635)" (App. Br. 4) The key question in this controversy is "How could he have done so?" He wasn't present or privy to Exxon's accounting decisions. The only information available to him for examination were the accounting products of such decisions which were related to hypothetical transactions which, of course, never in fact took place.

Thus, because of the uncertainties, hypothetical assumptions and complexity in any "separate accounting" approach for the attribution of "net income" of a multistate-multinational taxpayer to the states, irrespective of judicial precedent, Exxon has not established any valid reason why its "separate accounting" rather than unitary principles should control the disposition of its due process argument.

Exxon's due process and commerce clause arguments pertaining to the "situs income issue" is subject to the same inherent defects as its "separate accounting." This argument is but an adjunct to Exxon's "separate accounting" due process argument. This Court in *Moorman, supra,* specifically recognized that income

"source" principles (separate accounting) were irrelevant in determining the validity of an apportionment formula. Furthermore, it specifically held there that the commerce clause does not prevent the risk of multiple taxation which exists either from the states' utilization of different apportionment formulas or other specific attribution rules, including separate accounting and specific allocation.

ARGUMENT

A. The Appellant Conducted An Integrated Unitary Petroleum Business Partly Within And Without Wisconsin For The Years In Question. Any Reasonable Definition And Application Of What Constitutes A Unitary Business Clearly Establishes That Exxon Conducted A "Unitary" Business Of All Of Its Departments For The Years In Question And That All Of Its "Net Income" From Such Business, Including That From Its Situsted Property, Is Subject To Apportionment.

Since what constitutes a "unitary business" is a judicial concept developed to determine the constitutional scope of state taxing powers, particularly in the application of apportionment rules rather than separate accounting rules for the attribution of tax bases among the respective states, it is the judicial definition of this term which controls here. In this portion of the brief we will examine the tests employed by the judiciary to resolve this issue and then apply those tests to the facts and circumstances of this case.

1. The Judicial Definitions of What Constitutes a "Unitary" Business Establish that Exxon's Vertically Integrated Petroleum and Petroleum Related Business is "Unitary."

The unit rule of taxation first emerged in the state *ad valorem* property tax cases. In the latter part of the

19th century and the first part of the 20th century, this Court was confronted with a series of cases in the application of the unit rule to state *ad valorem* property taxation of interstate utilities in reference to federal constitutional restrictions on the states' power and jurisdiction to tax.[14]

In *Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194 (1896), rehearing 166 U.S. 185 (1897), this Court summarized its prior holdings:

> As to railroad, telegraph, and sleeping-car companies, engaged in interstate commerce, it has often been held by this court that their property in the several states through which their lines or business extended, might be valued as a unit for the

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14 *See, State R.R. Tax Cases*, 92 U.S. 575 (1875); *Kentucky R.R. Tax Cases*, 115 U.S. 321 (1885); *Western U. Tel. Co. v. Massachusetts*, 125 U.S. 530 (1887); *Pullman's Palace Car Co. v. Pennsylvania*, 141 U.S. 18 (1890); *Maine v. Grand Trunk Ry. Co.*, 142 U.S. 217 (1891); *Pittsburgh, Cin., Chi. & St. L. Ry. Co. v. Backus*, 154 U.S. 421 (1894); *Cleveland, Cin., Chi. & St. L. Ry. Co. v. Backus*, 154 U.S. 439 (1894); *American Refrig. Transit Co. v. Hall*, 174 U.S. 70 (1899).

> In *State R.R. Tax Cases*, the Court noted:
>
> That the franchise, capital stock, business, and profits of all corporations are liable to taxation in the place where they do business, and by the State which creates them, admits of no dispute at this day. "Nothing can be more certain in legal decisions," says this court in Society for Savings v. Coite, 6 Wall, 607, "than that the privileges and franchises of a private corporation . . . may be taxed by a State for the support of a State government." State Freight Tax Case, 15 Wall. 232; State Tax on Gross Receipts, 15 Wall. 284. (92 U.S. 603).

The argument was made by the taxpayers that the rolling stock, capital stock, and franchise or personal property which had a taxable situs at the principal place of business of the corporation could not be taxed by any other county, city or town. In answering this argument, the Court simply noted that the taxation of property at the principal place of business (commercial domicile) was a rule that could be changed by legislation.

> purposes of taxation, taking into consideration the uses to which it was put and all the elements making up aggregate value, and that a proportion of the whole fairly and properly ascertained might be taxed by the particular state, without violating any Federal restriction.

In *Adams Express Co., supra*, the Court then defined the unit subject to apportionment as a combination of the taxpayer's properties and values which constituted a "unit of use and management." However, it held that this unity constituted more than mere unity of ownership but rather a unity of use resulting from the nature of the business (165 U.S. at 221, 222).

In *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission, supra*, 266 U.S. 271 (1924) and *Underwood Typewriter Co. v. Chamberlain, supra*, 245 U.S. 113 (1920), this Court recognized that vertically integrated manufacturing and selling activities constituted a unitary business, the income from which was subject to formulary apportionment. In *Butler Bros. v. McColgan, supra*, 315 U.S. 501 (1942), unity was found on the basis of centralized management and centralized purchasing.

In *Maxwell v. Kent-Coffey Mfg. Co.*, 204 N.C. 265, 168 S.E., 397 (1933), aff'd without opinion, 291 U.S. 642 (1934), the court found that the term unitary business "is simply descriptive, and primarily means that the concern to which it is applied is carrying on one kind of a business, the component parts of which are too closely connected and necessary to each other to justify division or separate consideration, as independent units." (168 S.E. at 399) In *Wurlitzer Co v. State Tax Commission*, 35

N.Y.2d 100, 315 N.E.2d 805 (1974), the New York court treated a parent and its captive financial subsidiary as conducting a unitary business based primarily on unity of management and secondarily on unity of use. In *W.S. Dickey Clay Mfg. Co. v. Dickinson*, 200 Tenn. 25, 289 S.W.2d 533 (1956), the unity of ownership, centralized management and use (to a greater or lesser extent) resulted in a unitary business.

The Pennsylvania courts, in a series of decisions,[15] applied the interdepenence of the opertating units or divisions test to determine the existence of a unitary business. As there stated:

> [I]t is virtually impossible to envision a successful multiform claim [not unitary] based upon a separation of vertical functions of a corporation where the selling function deals in the products of the manufacturing and/or wholesaling functions. . . . [P]erformance by the corporate whole of policy, administrative, research and similar functions for otherwise independently operating units does

15 *Commonwealth v. Advance-Wilson Indus., Inc.*, 456 Pa. 200, 317 A.2d 642 (1974); *Morewood Realty Corp. v. Commonwealth*, 6 Pa. Commw. Ct. 244, 294 A.2d 219 (1972), aff'd, *Commonwealth v. Morewood Realty Corp.*, 458 Pa. 204, 327 A.2d 328 (1974); *Commonwealth v. ACF Indus., Inc.*, 441 Pa. 129, 271 A.2d 273 (1970); *Commonwealth v. Ford Motor Co.*, 350 Pa. 236, 38 A.2d 329 (1944); *Commonwealth v. Quaker Oats Co.*, 350 Pa. 253, 38 A.2d 325 (1944); *Commonwealth v. Minnesota Mining & Mfg. Co.*, 402 Pa. 612, 168 A.2d 560 (1961); *Logan Clay Prod. Co. v. Commonwealth*, 11 Pa. Commw. Ct. 629, 315 A.2d 346 (1974).

> not vitiate multiformity [non-unitary] any more than does their common but independent contributions of benefits to the corporate whole. *(Commonwealth v. ACF Indus., Inc.*, 441 Pa. 129, 271 A.2d 273, 279 [1970])

From *Western Auto Supply Co. v. Commissioner of Taxation*, 245 Minn. 346, 71 N.W.2d 797 (1955), "The test of whether a business is unitary is whether its various parts are interdependent and of mutual benefit so as to form one business unit rather than separate business entities and not whether the operating experience of the parts is the same in all places." The business there involved was unitary based on "reflected dependency, mutual contribution, and mutual benefit." (71 N.W.2d at 805) *Cf. Fleming v. Oklahoma Tax Comm'n*, 157 F.2d 888 (10th Cir. 1946).

What constitutes a unitary business has been the subject matter of considerable litigation in the states of California and Oregon, both in the single and multiple corporate (combined reporting) setting.[16] The California Supreme Court accepted the concept of unitary business enunciated by decisions of this Court. After noting that separate ac-

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16 California cases: *Appeal of F.W. Woolworth Co.*, [July 31, 1972] Cal. Tax Rep. (CCH) par. 204-806; *Chase Brass & Copper Co., Inc. v. Franchise Tax Bd.*, 10 Cal. App. 3d 496, 87 Cal. Rptr. 239 (1970). *cert. denied*, 400 U.S. 961 (1970); *Honolulu Oil Corp. v. Franchise Tax Bd.*, 60 Cal. 2d 417, 386 P.2d 40, 34 Cal. Rptr. 552 (1963); *Superior Oil Co. v. Franchise Tax Bd.*, 60 Cal. 2d 406, 386 P.2d 33, 34 Cal. Rptr. 545 (1963); *Butler Bros. v. McColgan*, 17 Cal. 2d 664, 111 P.2d 334 (1941), *aff'd*, 315 U.S. 501 (1942); *Edison California Stores, Inc. v. McColgan*, 30 Cal. 2d 472, 183 P.2d 16 (1947).

(footnote 16 continued on next page)

counting cannot be relied upon to disprove the propriety and presumption of fairness of formula allocation and after examination of the facts, it concluded:

> In accordance with the foregoing analysis, it is our opinion that the unitary nature of appellant's business is definitely established by the presence of the following circumstances: (1) unity of ownership; (2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) unity of use in its centralized executive force and general system of operation. *(Butler Bros. v. McColgan*, 17 Cal. 2d 664, 111 P.2d 334, 341 (1941), *aff'd*, 315 U.S.501 (1942).

In *Edison California Stores, Inc. v. McColgan*, 30 Cal. 2d 472, 183 P.2d 16 (1947), clarification was added. "If the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary; otherwise, if there is no such dependency, the busi-

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(footnote 16 continued)

Oregon cases: *Coca Cola Co. v. Department of Rev.*, 271 Or. 517, 533 P.2d 788 (1975); *Hamilton Mgmt. Corp. v. State Tax Comm'n*, 253 Or. 602, 457 P.2d 486 (1969); *John I. Hass, Inc. v. Ellis*, 227 Or. 170, 361 P.2d 820 (1961); *Zale-Salem, Inc. v. State Tax Comm'n*, 237 Or. 261, 391 P.2d 601 (1964); *Humble Oil & Refining Co. v. Department of Rev.*, 4 OTR 284 (1971).

ness within the state may be considered to be separate." (30 Cal. 2d at 481, 183 P.2d at 21)

The California test was further refined in *Superior Oil Co. v. Franchise Tax Board*, 60 Cal.2d 406, 386 P.2d 33, 34 Cal. Rptr. 545 (1963). The California tax authorities had argued that even though the California business operations contributed substantially to the taxpayer's out-of-state business and the California operations were substantially dependent upon the out-of-state operations, "[I]t must appear that the operations within and without the state are 'necessary and essential' to each other and to the functioning of the business as a whole."(386 P.2d at 37, 34 Cal. Rptr. at 549) For this argument the California taxing authorities relied on language in *Edison California Stores, supra*, wherein the court had used the word, "essential." In response to this argument, the court held that the use of the word "essential" in *Edison* was unfortunate and this Court in *Butler Bros.* simply held that the San Francisco branch contributed its adequate share to the advantages of centralized management of the unitary enterprise and to the total net income earned. In reference to *Butler Bros.*, it then concluded:

> [T]he test was not one based on essential activities, but rather based on contributing activities, and this court arrived at a similar result in Edison California Stores v. McColgan, *supra*, 30 Cal. 2d 472, at p. 481, 183 P.2d 16, at p. 21, wherein it concluded that operations are unitary if the business done within the state "is dependent upon or contributes to" the over-all operations. (386 P.2d at 38, 34 Cal. Rptr. at 550)

In applying the three unities and general dependency test of California, the court in *Chase Brass & Copper Co., Inc. v. Franchise Tax Board*, 10 Cal. App. 3d 496, 87 Cal Rptr. 239 (1970), *cert. denied*, 400 U.S. 961 (1970), determined, by major reliance on the overall control of the parent over the operations of its subsidiaries through management decisions at the highest level, that a parent and its subsidiary corporations conducted a unitary business.

In *Honolulu Oil Corp. v. Franchise Tax Board*, 60 Cal. 2d 417, 386 P.2d 40, 34 Cal. Rptr. 552 (1963) the California Franchise Tax Board alleged an absence of unity at the operating level which resulted in a lack of unity between Honolulu Oil's exploration and development activities (which were largely out-of-state) and its California local production and processing operations. Relying primarily on the facts of centralized control and operation of the entire business, the court found unity there because Honolulu Oil's business done within the state was dependent upon and contributed to the business done without the state.[17]

In *Chase Brass & Copper Co., Inc. v. Franchise Tax Board*, 10 Cal. App. 3d 496, 87 Cal. Rptr. 239 (1970),

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17 The court in *Honolulu Oil Corp.* relied on its decision in *Superior Oil Co. v. Franchise Tax Board*, 60 Cal. 2d 406, 386 P.2d 33, 34 Cal. Rptr. 545 (1963), to uphold the unitary concept. There was lacking in the *Superior Oil Co.* case any unity at the operational level. The court grounded its conclusion of a unitary operation in the *Superior Oil Co.* case on the basis that Superior's operations in California were substantially dependent upon out-of-state operations on (a) transfer of funds from out-of-state and borrowing on out-of-state assets to finance California operations; (b) legal counselling provided by company counsel outside of the state; (c) transfer of equipment and materials from out-of-state branches; (d) fiscal control; (e) technical and laboratory assistance and information; and (f) the transfer of employees from other branches.

cert. denied, 400 U.S. 961 (1970), the court placed considerable significance on the centralized executive force of the parent to determine that the parent and its subsidiary corporations conducted a unitary business.

> The integration of executive forces is an element of exceeding importance. It is top level management which is credited (or, in the case of failure or indifferent results, debited) with the effects of corporate enterprises. Chief executives of large organizations are regarded as highly prized acquisitions. They are induced to join a corporation, or to remain with it, and to exert their best efforts, not only by generous salaries, but also in many cases by incentive plans of various kinds. For a subsidiary corporation to have the assistance and direction of high executive authority of such a corporation as Kennecott is an invaluable resource. (10 Cal. App. 3d at 504)

In summing up the contours of a unitary business, Frank M. Keesling and John S. Warren, in an article entitled, "The Unitary Concept in the Allocation of Income," 12 Hastings L. Journal 42 (1960), stated:

> Briefly stated, for the purposes of allocation of income, a business may be defined as a separately owned group of activities each of which contributes to the production or earning of a given identifiable item of income, no portion of which can be segregated and specifically identified as being attributable to any one of the activities or any combination of activities less than the total number included in the group. (12 Hastings L. Journal 49)

Wilbur F. Lavelle, in an article entitled, "What Constitutes a Unitary Business," Southern California Tax Institute 239 (1973), defines a unitary business to be composed of the operations which ". . . are integrated with, dependent upon, or contribute to each other and the operations of the taxpayer as a whole." 1973 U.S.C. Law Center Tax Institute 246 (1973). Lavelle indicated that vertically integrated businesses with strong centralized management are generally considered unitary businesses.

The Oregon courts have followed the basic tests laid down by the California courts in determining whether a business is unitary. The Oregon Supreme Court in *Zale-Salem, Inc. v. State Tax Commission*, 237 Or. 261, 391 P.2d 601 (1964), held, on authority of *Edison California Stores*, and *Butler Bros.*, that parent and subsidiary corporations, engaged in the jewelry business, were conducting a unitary business.[18]

2. *Application of Judicial Definitions of What Constitutes a "Unitary" Business to Particular Factual Settings*

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18 *See also, Coca Cola Co. v. Department of Rev.*, 271 Or. 517, 533 P.2d 788 (1975). The Kansas Supreme Court defined unitary business in *Crawford Mfg. Co. v. State Comm'n of Rev. & Tax*, 180 Kan. 352, 304 P.2d 504 (1956) in essentially the same way.

Support Treatment of Exxon's Petroleum and Petroleum Related Business as "Unitary."

A cardinal example of a unitary business is a railroad system. In *Fleming v. Oklahoma Tax Commission, supra*, 157 F.2d 888 (10th Cir. 1946), the Tenth Circuit had no trouble in dtermining that a railroad system constituted a unitary business.

> The very nature of a vast continental or interstate transportation system brings it especially within this concept of a unitary business. A railroad may likened to a spider's web, in which all the strands are necessary to the common design and each contributes its necessary part to a single goal. It may be true, as urged by the Railroad, that the Chicago to Denver branch could be operated profitably by itself and that the income realized from its operation can be ascertained. It does not, however, follow that it could be operated as profitably by itself or that its income would be as great as it is as a part of a large railway network in which other parts lessen overhead burdens or funnel business to the system, which ultimately finds its way to this branch. No doubt its connection with the rest of the system brings it business which otherwise might well go elsewhere. To this extent it is dependent upon the rest of the system, and it cannot be said that no part of the income realized from the operation of this branch does not accrue by virtue of its connection with a large railway transportation system. (157 F.2d at 891)

In *Butler Bros. v. McColgan, supra*, the question was whether a wholesale dry goods and general merchandising business constituted a unitary business or whether the specific wholesale locations could be treated as separate businesses. As a result of the activities of a central buying division, a central advertising division and a central accounting and management division, the Supreme Court of California and this Court held that the business of Butler Brothers was unitary.

The Supreme Court of Minnesota arrived at a comparable result in reference to a Missouri corporation engaged in the retail and wholesale merchandising of automotive parts and accessories and other merchandise on a nationwide basis. In *Western Auto Supply Co. v. Commissioner of Taxation*, 245 Minn. 346, 71 N.W.2d 797 (1955), the taxpayer sought to divorce its wholesaling activity from its retailing activity and separately account for its retailing activity in Minnesota. The court there noted the relationship of the centralized activity of the taxpayer to its retail operations and noted the reciprocity of their activities.

> The taxpayer, in its analysis of the sources of its profit, treats its business as if it were made up of independent, separate business units. The fact remains that the buying profit and the administrative profit . . . [were] created by the operation of the entire

business unit, through the coordinated and standardized activity of numerous stores throughout the country which made possible the central purchasing, the central management, the warehousing as carried on, and the advertising methods adopted. The stores in Minnesota contributed in part to make all this possible, and the multiple-formula method simply allocates a fair share of the profit to Minnesota, a share corresponding to the contribution of the taxpayer's Minnesota operation (measured by its Minnesota property, payroll, and sales activity) to the existence and operation of the taxpayer's entire business unit. (71 N.W. 2d at 805)

In *Edison California Stores, Inc. v. McColgan, supra,* the court found that a parent and its subsidiary corporations engaged in the purchasing and retailing of ladies shoes, accessories, and costume jewelry conducted a unitary business. It could not distinguish the *Edison* case factually from the *Butler Bros.* case, *supra.*

A parent and its wholly owned subsidiaries owning and operating retail jewelry stores also have been adjudged a unitary business. *Zale-Salem, Inc. v. State Tax Comm'n, supra.* The parent company exercised strict accounting and management control and supervision over the separately incorporated local stores.

A corporation, such as Exxon, engaged in the business of manufacturing, sale and distribution of products (a

vertically integrated business), has generally been held to be engaged in a unitary business.[19] This simply follows from the fact that "net income" is a result of various integrated activities and transactions culminating in sales; and that it is not possible to determine what part of "net income" is attributable to the separate but integrated activities of manufacture, sale, distribution, and so forth.

In *Humble Oil and Refining Co. v. Department of Rev.*, 4 OTR 284 (1971), the court found that an integrated oil company was unitary:

> Humble Oil and Refining Company is a large vertically integrated, corporation engaged nationwide in all phases of the petroleum industry, from discovery through production and manufacture to marketing. It has unity of ownership, operations, management, control and products; and strong centralized credit, purchasing, advertising, accounting and legal services. All segments of plaintiff's business have a great deal in common and contribute to and are dependent upon each other. The plaintiff is actually a single interrelated unitary business operation. The component parts, including those in Oregon, are too closely connected and necessary to each other to be considered as independent units. . . .

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19 *Underwood Typewriter Co. v. Chamberlain,* 245 U.S. 113 (1920). "The profits of the corporation were largely earned by a series of transactions beginning with manufacturing in Connecticut and ending with sale in other states." *Id.* at 120.

> Producing in one state and selling in another depends upon a multitude of interdependent operations, and although the petroleum Humble sold in Oregon was not its own production but that of a third party, the sales nevertheless were made possible by the company's own production. If plaintiff wasn't producing it wouldn't be selling, and what plaintiff did in Oregon was not due solely to conditions here, but was dependent upon the market elsewhere and upon plaintiff's production and manufacturing elsewhere. The marketing in Oregon was an integrated part of plaintiff's nationwide business and undoubtedly was beneficial to the corporation as a whole. It was not a completely separate, independent or local endeavor. Plaintiff's production and refining conform to the demands of the nationwide market, and the court believes plaintiff expanded into Oregon to increase demand for its products so that it could increase production and refining and thus increase profits and its stature in the industry. (*Id.* at 292-93)

In *Coca-Cola Co. v. Department of Rev., supra*, the Supreme Court of Oregon had no difficulty in finding that the Coca-Cola Company and its wholly owned bottling subsidiaries conducted a unitary business subject to apportionment. Factors included a substantial dependency of the subsidiaries on the parent's centralized management and control and a flow of products from the parent to the

subsidiaries. Coca-Cola's "arms'-length" dealings with its subsidiaries was held to be immaterial to resolution of the "unitary" issue.

John Deere Plow Co. of Moline v. Franchise Tax Board, 38 Cal. 2d 214, 238 P.2d 569 (1951), is a good illustration of the factual pattern necessary to be developed to show interdependence and centralized control of the business enterprise giving rise to the application of the unitary concept.

In the referred-to cases, where there was a substantial flow of goods between the different departments or corporations constituting the unitary group as well as strong centralized management and control, a unitary business was found to exist. Since the profits were traceable directly in part to centralized operations and interfunctional operations, a unitary business was found to exist.

3. *Application of the Unitary Tests to the Facts of this Case Clearly Establishes that Exxon Conducted a Unitary Business for the Years in Question.*

The application of any reasonable definition of what constitutes a unitary business to the admittedly integrated petroleum business of Exxon with its strong centralized and complex management and supervision and the interrelations of its various operation departments (including a flow of goods) unequivocally establishes that it was conducting a unitary business in regard to all of its operating departments involved in its gas and oil enterprises. In fact,

every criteria that can be used to describe a unitary business was present in regard to Appellant's activities for the years in question. This is demonstrated by the Statement and Analysis of Facts, *supra*, at pages 14-36 of this brief.

Any doubt about that is dispelled by the participation of Exxon and other major oil companies and their spokesmen in the hearings before the Subcommittee on Anti-Trust and Monopoly of the Committee on the Judiciary United States Senate 94th Congress, 1st Session on S2387 and related bills entitled, "The Petroleum Industry-Vertical Integration (S2387)." Most of the testimony on behalf of the oil companies in those proceedings characterized the splitting up of the integrated functions of major integrated oil companies as "dismemberment." These spokesmen further testified that any such dismemberment would change the whole nature and structure of the petroleum industry in the United States. In fact, in those hearings, as indicated above, footnote 12 at pages 35-39, Exxon told this Committee that its e & p, refining, marketing and transportation functional activities constituted a unitary business and that its books and records were kept on a company and not a functional department basis. Therefore, Exxon could not give the Committee a separate profit statement for its major operating functions of production, refining, marketing and transportation.

This case does raise, then, only the fundamental question of whether accounting principles which are utilized for internal accounting and management purposes determines the due process limitations of state taxing powers as pertains to a vertically integrated unitary business. If Exxon is right in its argument, judicial precedent pertaining to the application of apportionment and unitary principles which have been analyzed above are meaningless pieces of paper. For, we can imagine no stronger case for the application of unitary principles than that demonstrated by the unitary operations of a wholly integrated vertical petroleum business. The facts pertaining to Humble's unitary operations set forth in *Humble*, *supra*, by the Oregon Tax Court--which are not in conflict and are supported by the record in this case--alone support this conclusion. If Exxon's "separate accounting" controls here, we can imagine no multistate business which could not attribute its profits to the respective states--irrespective of the unitary nature of the business--by some method of generally accepted accounting.

B. Exxon's activities in Wisconsin for the years in question clearly exceeded any due process requirements inasmuch as it conducted substantial business activities in Wisconsin for the years in question which exceeded any minimum nexus due process requirement and inasmuch as its Wisconsin operations were related to and not disassociated from its activities which produced the "net income" subject to apportionment by Wisconsin.

The general due process standard applicable to an apportioned state income tax is stated as follows in *Northwestern States Portland Cement Co. v. Minnesota*, *supra*, 358 U.S. 450:

> Nor will the argument that the exactions contravene the Due Process Clause bear scrutiny. The taxes imposed are levied only on that portion of the taxpayer's net income which arises from its activities within

the taxing State. These activities form a sufficient "nexus between such a tax and transactions within a state for which the tax is an exaction." *Wisconsin v. J.C. Penney Co.*, *supra*, at 445. . . . The record is without conflict that both corporations engage in substantial income-producing activity in the taxing States. . . . As was said in *Wisconsin v. J.C. Penney Co.*, *supra*, the "controlling question is whether the state has given anything for which it can ask return." Since by "the practical operation of [the] tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred . . ." it "is free to pursue its own fiscal policies, unembarrassed by the Constitution . . ." *Id.*, at 444. (358 U.S. at 464, 465)

As otherwise stated in *Moorman*, *supra:*

> The Due Process Clause places two restrictions on a State's power to tax income generated by the activities of an interstate business. First, no tax may be imposed unless there is some minimal connection between those activities and the taxing State. *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753, 756. . . . Second, the income attributed to the State for tax purposes must be rationally related to "values connected with the taxing state." *"Norfolk & Western R. Co. v. Missouri*, 390 U.S. 317, 325 (437 U.S. 267 at 272-273)

Notwithstanding the fact that its activities in Wisconsin clearly exceeded any due process nexus requirements and notwithstanding the fact that the net income subject to tax was reasonably related to its Wisconsin activities by application of unitary principles, Exxon attempts to attribute its e & p and refining income to out-of-state sources for due process purposes by "separate accounting."

In so doing, it relies on two faulty premises, namely, (1) that Wisconsin is imposing an income tax on its income from its out-of-state e & p and refining activities; and (2) that the income derived from these activities is totally disassociated from and unrelated to its Wisconsin business activities and operations. Neither of these propositions is true.

The fact that income or properties is included in the tax base subject to apportionment which by "separate accounting" would be attributable to out-of-state sources and activities has never triggered invalidation of an apportionment formula, so long as the taxpayer has not shown that the apportionment result reached extra-territorial values or income. *Butler Bros. v. McColgan*, 315 U.S. 501 (1942).

In contending that Wisconsin is attempting to tax its income derived from out-of-state activities or sources, Exxon misconstrues the operative effect of the formula method of computing taxable income. In answering Moorman Manufacturing Co.'s argument that the Iowa single-sales-

factor apportionment formula sought to tax income attributable to Moorman's manufacturing operations in Illinois, this Court stated in *Moorman*:

> Since 1934 Iowa has used the formula method of computing taxable income. *This method, unlike separate accounting, does not purport to identify the precise geographical source of a corporation's profits; rather, it is employed as a rough approximation of a corporation's income that is reasonably related to the activities conducted within the taxing State.* The single-factor formula used by Iowa, therefore, generally will not produce a figure that represents the actual profits earned within the State. But the same is true of the Illinois three-factor formula. Both will occasionally over-reflect or under-reflect income attributable to the taxing State. Yet despite this imprecision, the Court has refused to impose strict constitutional restraints on a State's selection of a particular formula. See, *e.g., Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113; *Bass, Ratcliff & Gretton v. State Tax Commission*, 266 U.S. 271; *Ford Motor Co. v. Beauchamp*, 308 U.S. 331. (437 U.S. 267 at 273; emphasis added)

Thus, Exxon's due process of law argument must be rejected because it has not shown that the income attributed to Wisconsin by the apportionment formula was not "rationally related by 'values connected with the taxing state'--*Norfolk & Western R. Co. v. State Tax Comm'n*, 390 U.S. 317, 325." *(Moorman*, 437 U.S. 267 at 273)

What Exxon completely ignores in its due process clause argument is that *unitary apportionment* principles--*not "separate accounting"* source principles--apply without exception, when a state seeks to tax integrated business operations which are conducted both within and without its borders. Exxon argues that "separate accounting" rules are relevant within the limited context of the attribution of its gross income from its e & p, refining and marketing activities and that apportionment rules and unitary principles otherwise apply. Apportionment principles would apparently pertain to those substantial expenses which are common to its overall business operations (characterized as "administrative" on its federal income tax returns and amounting to in excess of one-third of its 27.1 billion dollars in gross income for the years in question [A761-A765]). This is an inappropriate, hybrid method of attributing income to either Exxon's Wisconsin income sources or income producing activities.

As indicated in an article entitled, "Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business," by Jerome R. Hellerstein, XXI National Tax Journal 487, 496:

> The underlying justification for applying an apportionment formula to the overall tax base of a multistate business is that there exists a unitary enterprise being carried on in more than one state. The formula is a device for attributing to the taxing state

its share of the overall tax measure that admittedly is attributable ony in part to the state. . . . By applying the typical three factor formula, the property, receipts and payroll ratios of all branches, subsidiaries and affiliates are taken into account in determining apportionment ratios, which are then applied to the tax base of the entire business.

[A]t the center of many of the cases, the crucial controversy has been the delineation of the contours of a unitary business. (Footnotes omitted)

Starting with the early utility property tax cases, this Court has uniformly upheld the apportionment of the entire properties, values or income attributable to a unitary business by an apportionment formula which has not been demonstrated by the taxpayer by clear and cogent evidence to tax extraterritorial income or values.

In the *Adams Express Co.* case, *supra*, this Court held that all of the property of the express company which was used in its trade or business, including its intangible assets, were properly subject to apportionment for ad valorem property tax purposes. Furthermore, this Court there held that:

> There is here no attempt to tax property having a situs outside of the state, but only to place a just value on that within. Presumptively, all the property of the corporation or company is held and used for the purposes of its business, and the value of its capital stock and bonds is the value of only that property so held and used. (167 U.S. 227)

This Court therefore concluded in the *Adams Express Co.* case that the total market value of the stock of the express company could be taken into consideration in valuing its properties within the taxing state, even though its intangibles had a specific situs outside the taxing state at the "commercial domicile."

It is thus clear that the *Adams Express Co.* cases and cases relied on therein clearly establish a unit rule or unitary concept for state tax purposes and permits a state to determine the instate privilege, property or income by reference to the total privileges, property or income of the multistate business if there is a unitary relationship between the instate activities or property of the business and its total activities or properties everywhere. They also establish the proposition that the state of "situs" of property has no special claim to tax the properties or values connected with the unitary business and that all such values and properties, wherever located, are appropriately included in the tax base subject to apportionment.

The principles of these early "unit rule" cases were subsequently uniformly applied by this Court to corporate "net worth" franchise and "net income" taxes. In the application of the "unit rule" to corporate franchise taxes, this Court in *Flint v. Stone Tracy Co., supra,* 220 U.S. 107 (1911) and *Ford Motor Co. v. Beauchamp, supra,* 308 U.S. 331 (1939) upheld the apportionment of all the property used in a unitary business. It there recognized that the total properties of large multistate-multinational corporations contributed substantially to their business which they conducted in the various states.

This Court in *Ford Motor Co., supra*, held that its decisions in *Bass, Ratcliff & Gretton v. State Tax Commission, supra*, 266 U.S. 271 (1924) and *National Leather Co. v. Massachusetts*, 277 U.S. 413 (1927), were directly applicable.

In *Bass, Ratcliff & Gretton v. State Tax Commission, supra*, 266 U.S. 271 (1924), this Court stated:

> In *Wallace v. Hines*, 253 U.S. 66, 69, it was recognized that a State, in imposing an excise tax upon foreign corporations in respect to doing business within the State, may look to the property of such corporations beyond its borders to "get the true value of the things within, when they are part of an organic system of wide extent," giving the local property a value above that which it would otherwise possess, and may therefore take into account property situated elsewhere when it "can be seen in some plain and fairly intelligible way that it adds to the value of the (property) and the rights exercised in the State." This is directly applicable to the carrying on of a unitary business of manufacturing and sale partly within and partly without the State.

The unit rule of taxation, which included a reasonable apportionment of all properties and values, as developed in the *Adams Express Co.* cases was first applied to taxes on or measured by net income in *Underwood Typewriter Co. v. Chamberlain, supra*. In the *Underwood* case, a tangible property apportionment factor was used to apportion

to Connecticut manufacturing activities ". . . income upon which the corporation is required to pay a tax to the United States." (254 U.S. 117, 118) In challenging the constitutionality of the apportionment formula, the taxpayer contended that the net income included income from properties not connected with its Connecticut manufacturing business (254 U.S. 114-116). In disposing of the taxpayer's arguments, this Court focused its attention solely on the validity of the apportionment result.

Four years later, in *Bass, Ratcliff & Gretton, supra*, this Court held that the world-wide property and income of a British unitary enterprise were a necessary part of the apportionment computations in measuring the true value of its income attributable to New York. The taxpayer was found to be "a British corporation, engaged in brewing and selling Bass's ale" which it imported and sold in New York City and Chicago. (*id.*, at p. 278) It had world-wide net income of $2,185,600, but "the Company, as reported to the United States by "separate accounting," had no net income upon which it was subject to a federal income tax." (*id.*, at p. 279) New York imposed a 3% tax which Bass paid under protest.

On appeal, Bass contended that the tax was imposed "upon a portion of its net income derived from business carried on outside of the United States . . ." (*id.*, at p. 280). This Court decisively rejected this contention. It held that Bass ". . . carried on the *unitary* business of manufacturing and selling ale, in which its profits were *earned in a series of transactions* beginning with manufacture in England and ending in sales in New York . . ." (*id.*, at p. 282). Having found Bass to be a unitary business operation, this Court affirmed that a fair measuring of taxes due the State required an apportionment of all of Bass' income from its unitary business.

Again, in *Butler Bros. v. McColgan*, 315 U.S. 501 (1942), this Court applied the unit rule it had expressed in the *Adams Express Co.* cases, *supra*, and its observations in *Flint v. Stone Tracy Co.*, *supra*, and *Ford Motor Co. v. Beauchamp*, *supra*, in determining the validity of the apportionment result challenged in *Butler Bros.* It there found:

> At least since *Adams Express Co. v. Ohio*, 165 U.S. 194, 17 S. Ct. 305, this Court has recognized that the unity of use and management of a business which is scattered through several States may be considered when a State attempts to impose a tax on an apportionment basis.
>
> . . . . .
>
> We cannot say that property, payroll, and sales are inappropriate ingredients of an apportionment formula. We agree with the Supreme Court of California that *these factors may properly be deemed to reflect "the relative contribution of the activities in the various states to the production of the total unitary income," so as to allocate to California its just proportion of the profits earned from this unitary business. And no showing has been made that income unconnected with the unitary business has been used in the formula.* (Emphasis added, 315 U.S. 507-508)

In *U.S. Steel Corp. v. Multistate Tax Commission*, 434 U.S. 452 (1978), this Court stated:

> The "unitary business" technique involves calculating a corporate taxpayer's net income on the basis of all phases of the operation of a single enterprise (*e.g.*, production of components, assembly, packing, distribution, sales), *even if located outside the jurisdiction*. The portion of that income attributable to activities within the taxing State is then determined by means of an apportionment formula. *See, e.g., Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920). (434 U.S. 473, n. 25; emphasis added)
>
> . . . . .
>
> Individual States are free to employ the unitary-business standard. *Underwood Typewriter Co. v. Chamberlain*, *supra*; accord, *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271 (1924). (434 U.S. 474, n. 26)

As the above decisions amply demonstrate, the fact that the Wisconsin tax base, prior to apportionment, included income from out-of-state properties and activities is totally irrelevant. To the extent income is attributable to out-of-state properties and activities, this is reflected in a determination of apportionable unitary income and the apportionment factors.

Notwithstanding the clear and unequivocal holdings of the foregoing cases, Exxon contends that the unitary principles have no due process significance if their application produces a tax result substantially in excess of a tax result arrived at by "separate accounting." What Exxon fails to realize is that this Court has never held that "separate accounting" *per se* invalidates the tax result arrived at by applying a reasonable apportionment formula to the total unitary tax base of a multistate-multinational corporation.

The relationship of what Appellant characterizes as the unitary *per se* principle to "separate accounting" was specifically considered by this Court in its disposition of *Butler Bros. v. McColgan, supra.* As Exxon does here, the taxpayer in *Butler Bros.*, by reliance on *Hans Rees' Sons v. North Carolina*, 283 U.S. 123 (1931), sought to invalidate the California apportionment formula result by "separate accounting." As noted by this Court in *Butler Bros.*:

> *Hans Rees' Sons v. North Carolina*, 283 U.S. 123, constitutes appellant's chief support in its attack on the formula employed and the tax imposed by California. Appellant maintains that the use of the formula in question resulted in converting a loss of $82,851 into a profit of over $93,500 and that the difference of some $175,000 has either been created out of nothing or has been appropriated by California from other states. (315 U.S. at 506)

This Court in disposing of Butler Bros.' separate accounting argument then stated:

> We take a different view. We read the statute as calling for a method of allocation which is "fairly calculated" to assign to California that portion of the net income "reasonably attributable" to the business done there. The test, not here challenged, which has been reflected in prior decisions of this Court, is certainly not more exacting. *Bass, Ratcliff & Gretton, Ltd. v. Tax Commission*, 266 U.S. 271; *Ford Motor Co. v. Beauchamp*, 308 U.S. 331. *Hence, if the formula which was employed meets those standards, any constitutional question arising under the Fourteenth Amendment is at an end.*
>
> One who attacks a formula of apportionment carries a distinct burden of showing by "clear and cogent evidence" that it results in extraterritorial values being taxed. See *Norfolk & Western Ry. Co. v. North Carolina*, 297 U.S. 682, 688. This Court held in *Hans Rees' Sons v. North Carolina, supra*, p. 135, that the burden had been maintained on a showing by the taxpayer that *"in any aspect of the evidence"* its income attributable to North Carolina was *"out of all appropriate proportion to the business"* transacted by the taxpayer in that State. No such showing has been made here.
>
> It is true that appellant's separate accounting system for its San

Francisco branch attributed no net income to California. But we need not impeach the integrity of that accounting system to say that it does not prove appellant's assertion that extraterritorial values are being taxed. Accounting practices for income statements may vary considerably according to the problem at hand. Sanders, Hatfield & Moore, A Statement of Accounting Principles (1938), p. 26. A particular accounting system, though useful or necessary as a business aid, may not fit the different requirements when a State seeks to tax values created by business within its borders. Cf. Hamilton, Cost as a Standard for Price, 4 Law & Contemporary Problems 321. That may be due to the fact, as stated by Mr. Justice Brandeis in *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 121, that a State in attempting to place upon a business extending into several States "its fair share of the burden of taxation" is "faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders." *Furthermore, the particular system used may not reveal the facts basic to the State's determination. Bass, Ratcliff & Gretton, Ltd. v. Tax Commission, supra*, p. 283. *In either aspect of the matter, the results of the accounting*

system employed by appellant do not impeach the validity or propriety of the formula which California has applied here.

At least since *Adams Express Co. v. Ohio*, 165 U.S. 194, this Court has recognized that unity of use and management of a business which is scattered through several States may be considered when a State attempts to impose a tax on an apportionment basis. As stated in *Hans Rees' Sons v. North Carolina, supra*, p. 133, ". . . the enterprise of a corporation which manufactures and sells its manufactured product is ordinarily a unitary business, and all the factors in that enterprise are essential to the realization of profits." And see *Bass, Ratcliff & Gretton, Ltd. v. Tax Commission, supra*, p. 282. By the same token, California may properly treat appellant's business as a unitary one. Cf. *Great Atlantic & Pacific Tea Co. v. Grosjean*, 301 U.S. 412. (315 U.S. 506-508; emphasis added)

In *John Deere Plow Co. v. Franchise Tax Board, supra*, 38 Cal. 2d 214, 238 P.2d 569 (1951), appeal dismissed for want of a substantial federal question, 343 U.S. 939 (1952), the taxpayer again sought to rely on elaborate "separate accounting" data to invalidate the results of the California apportionment formula as applied to the unitary income of a unitary trade or business. California there noted that formulary apportionment:

. . . is not framed on the assumption that there must be uniformity of operating revenues and expenses in the relative functions of the various units contributing to the earnings of an integrated, multistate business and concluded that the attack on the formula by proof of the higher costs and the less profitable nature of the California business misconceives the whole purport of the unit rule of assessment, which rests on the principle that "where a business is unitary in character, so that its separate parts cannot be fairly considered by themselves and the whole business in the several states derives a value from the unity of use, allocation of income upon a reasonable formula is properly sustained." (38 Cal. 2d at 228, 238 P.2d at p. 577)

In regard to the taxpayer's reliance on "separate accounting" in *John Deere Plow Co.*, the California Supreme Court further noted:

> But in so arguing plaintiff fails to take into account the underlying concept of formula apportionment in the allocation of income from a unitary business: that the unitary income is derived from the functioning of the business as a whole, to which the activities in the various states contribute; and that by reason of such interrelated activities in the integrated overall enterprise, the business done within the state is not truly separate and distinct from the business done without the state so as reasonably to permit of a segregation of income under the separate accounting method rather than use of the formula method in assigning to the taxing state its fair share of taxable values. Butler Brothers v. McColgan, supra, 17 Cal.2d 664, 667-668, 111 P.2d 334; Edison California Stores v. McColgan, supra, 30 Cal.2d 472, 477-479, 183 P.2d 16; El Dorado Oil Works v. McColgan, supra, 34 Cal.2d 731, 735, 215 P.2d 4. . . . The fact that the taxpayer may show that according to a separate accounting system, the activities in the taxing state were less profitable than those without the state, or even resulted in a loss, does not preclude use of a formula as a method of apportionment of the unitary income. (Ibid.) The only requirement is that the formula used be not intrinsically arbitrary or produce an unreasonable result. Such was the situation in the case of Hans Rees' Sons v. State of North Carolina ex rel. Maxwell, 283 U.S. 123, 51 S.Ct. 385, 75 L.Ed. 879, where the court recognized the unitary character of the business as a manufacturing and selling enterprise extending into several states and to which a formula

method of apportionment was appropriate, but refused to approve the particular formula employed for the reason that it consisted simply of the property factor and failed to give proper weight to the extensive activities of the company without the state, so that the result reached was unreasonable. See Butler Brothers v. McColgan, supra, 17 Cal.2d 664, 673, 111 P.2d 334, Southern Pacific Co. v. McColgan, 68 Cal. App. 2d 48, 60, 156 P.2d 81.

Varying conditions in the different states wherein the integrated parts of the whole business function must be expected to cause individual deviation from the national average of the factors in the formula equation, and yet the mutual dependency of the interrelated activities in furtherance of the entire business sustains the apportionment process. North American Cement Corp. v. Graves, supra, 299 U.S. 517, 57 S.Ct. 311, 81 L.Ed. 381; Ford Motor Co. v. Beauchamp, 308 U.S. 331, 336, 60 S.Ct. 273, 84 L.Ed. 304. (238 P.2d 573-574)

Notwithstanding the unequivocal holdings in *Butler Bros., supra,* and *John Deere Plow Co., supra,* (dismissed by this Court on appeal for the lack of a substantial federal question), nevertheless Exxon, by reliance on *Hans Rees', supra,* and this Court's dictum in *Moorman Mfg. Co. v.*

Bair, supra, argues that its "separate accounting" controls disposition of this case. However, neither *Hans Rees'* nor *Moorman* turned upon "separate accounting." *Hans Rees'* turned on an unequivocal proffer of *conclusive evidence* (not "separate accounting") that the apportionment result arrived at by North Carolina's use of a single property factor apportionment formula was unrelated to instate income producing activities. In disposing of *Hans Rees'*, this Court held:

> For the present purpose, in determining the validity of the statutory method as applied to the appellant, it is not necessary to review the evidence in detail, or to determine as a matter of fact the precise part of the income which should be regarded as attributable to the business conducted in North Carolina. It is sufficient to say that, in any aspect of the evidence, and upon the assumption made by the state court with respect to the facts shown, the statutory method, as applied to appellant's business for the years in question operated unreasonably and arbitrarily, in attributing to North Carolina a percentage of income out of all appropriate proportion to the business transacted by the appellant in that State. In this view, the taxes as laid were beyond the State's authority. *Shaffer v. Carter,* 252 U.S. 37, 52, 53, 57.

For this reason the judgment

> must be reversed and the cause remanded for further proceedings not inconsistent with this opinion. (283 U.S. 135-136)

In no sense can this case be held for authority that a taxpayer's "separate accounting" of its unitary income invalidates a three-factor apportionment formula applied to the unitary income of a unitary trade or business.

Nor is the dictum of this Court in *Moorman Mfg. Co. v. Bair, supra*, relating to "separate accounting" of any controlling significance. This Court's reference to the fact that Moorman failed to show what part of its profits was attributable to sales, to manufacturing or to any other phase of its operations by "separate accounting" (437 U.S. at 272) cannot be reasonably cited for the proposition that "separate accounting" can invalidate the reasonable apportionment of the unitary income of a unitary trade or business. The same is true in regard to this Court's reference to "separate accounting" in footnote 9 of the *Moorman* case. This Court there simply quoted from the statement of Justice McCormick in the Iowa Supreme Court *Moorman* opinion pertaining to the taxpayer's failure to utilize "sophisticated accounting techniques" to show that the Iowa single-factor apportionment formula produced an arbitrary result (437 U.S. 267 at 275). *Moorman* in no way overruled this Court's holding in *Butler Bros. v. McColgan, supra*, that "separate accounting" for the unitary income of a unitary trade or business can invalidate an otherwise reasonable apportionment of the entire net income of a unitary trade or business. In fact, in *Moorman* in commenting on a single-factor apportionment formula, this Court stated:

> In individual cases, it is true, the Court has found that the *application* of a single-factor formula to a particular taxpayer violated due process. See *Hans Rees' Sons v. North Carolina ex rel. Maxwell*, 283 U.S. 123; *Norfolk & Western R. Co. v. State Tax Comm'n, supra*. In *Hans Rees'*, for example, the Court concluded that proof that the formula produced a tax on 83% of the taxpayer's income when only 17% of that income actually had its source in the State would suffice to invalidate the assessment under the Due Process Clause. But in neither *Hans Rees'* nor *Norfolk & Western* did the Court depart from the basic principles that the States have wide latitude in the selection of apportionment formulas and that a formula-produced assessment will only be disturbed when the taxpayer has proved by "clear and cogent evidence" that the income attributed to the State is in fact "out of all appropriate proportion to the business transacted . . . in that State," 283 U.S., at 135, or has "led to a grossly distorted result," 390 U.S., at 326. (437 U.S. 274)

Thus, the unitary principles which are applicable in determining the reasonableness of an apportionment result are dispositive of Exxon's due process of law "separate accounting" argument.

C. Exxon's "Separate Accounting" Does Not Establish That Wisconsin Has Attributed Income To Wisconsin Sources Unrelated To Exxon's Wisconsin Privileges, Activities An Income Sources.

Apart from its "separate accounting" argument, Exxon has not sought to establish that the well-recognized three-factor apportionment formula of Wisconsin has attributed income to Wisconsin not reasonably and rationally related to Exxon's substantial business activities in Wisconsin for the years in question.

Exxon's entire due process argument is based on the faulty premise that if "separate accounting" of its marketing activities attributes to Wisconsin an amount of "net income" substantially less than attributable to Wisconsin by Wisconsin's apportionment formula as applied to its marketing, refining and e & p activities combined, this proves that the apportionment result subjects "net income" unrelated to its Wisconsin activities, privileges and income sources to taxation. This argument of Exxon suffers from the same defects as Moorman's due process argument in the *Moorman* case, *supra*. In *Moorman*, Moorman could not show that even a single sales factor apportionment formula in fact apportioned to Iowa any "net income" Moorman would not have realized for the years there involved if it had not utilized Iowa for a market for approximately 20% of its products. Moorman simply argued that a three-factor formula would attribute less income to Iowa than the single sales-factor formula. Exxon is advancing the identical argument here by a comparison of its "separate accounting" for its marketing activities both within and without Wisconsin to the apportionment of its e & p, refining and marketing activities.

By apportionment of its marketing activities, separate from its e & p and refining activities, $2,086,607 "net income" was attributed to Wisconsin for the years in question (Exh. 28, A760). Apportionment of "net income" from all of its activities (primarily e & p, refining and marketing), attributed $4,532,155 "net income" to Wisconsin for the years in question (Exh. 28, A760). Thus, the "net income" in dispute in this appeal is $2,445,548, which Exxon claims was unconstitutionally taxed by Wisconsin. Since there was surplus crude oil on the American market and since Exxon had substantial excess refining capacity for the years in question, no one knows what Exxon's profits would have been from *any* of its operations but for its Wisconsin marketing activities. Exxon's "net income" from its e & p and refining operations may well have equalled substantially less than the differential here in dispute if it had conducted no marketing activities in Wisconsin for the years in question. This clearly demonstrates the hypothetical nature of Exxon's "separate accounting" argument. Furthermore, if for the years in question Exxon conducted no marketing activity whatsoever, which is the premise on which Exxon's "separate accounting" of its e & p and refining activities is premised, no one knows what "net income" Exxon would have realized from the balance of its operations. This alone dispells any notion that Wisconsin has measured Exxon's corporate privilege tax by any "net income" unrelated to its marketing activities in Wisconsin.

There are other basic fallacies in Exxon's "separate accounting" *per se* due process argument. Exxon's witnesses testified at length as to the reasonableness of it's "separate accounting" results. They explained in great detail how its e & p, refining and marketing *gross receipts* were reasonably related to market conditions. However, as heretofore indicated, their testimony further established

that the "separate accounting" results were a product of internal negotiations between e & p, refining and marketing, and hypothetical third-party dealings. That this "separate accounting" introduces some room for error, discretion and judgment can hardly be denied. This follows from the fact that its "separate accounting" was based on hypothetical transactions with third parties.

While these possible accounting discretions may be adequate for internal accounting controls and even for tax and royalty payments based on *gross receipts*, it takes little imagination to realize that "separate accounting" deductions can materially affect the attribution of *"net income"* among various segments of a vertically integrated business. This can be demonstrated by reference to Exxon's "federal taxable income" for the years in question as comparable to its total gross receipts. It can be further illustrated by the percentage of "accounting" error which represents the "net income" attributable to Wisconsin which is in dispute in this case.

For these years, Exxon's total receipts were approximately 27.183 billion dollars and its total federal taxable income was approximately 1.222 billion dollars, as declared on its federal income tax returns (Exh. 28, A760-A765). Federal taxable income represented approximately 4.5% of Appellant's gross receipts. If "separate accounting" were 95.5% accurate (20 to 1), such error could completely eliminate any federal taxable income for any of the Appellant's operating departments or more than assign the total income to any particular operating department.

For the years in question, approximately $308,371.00 of federal taxable income was assigned to the marketing function, $650,132 to the e & p function, and $233,754 to the refining function by "separate accounting" of the net income of these functions (Exh. 28, A760-A765). Given the fact that Exxon's gross receipts for the years in question amount to 27.183 billion dollars, it takes little imagination to see that a very small accounting error or discretion could substantially shift these profits.

The room for "separate accounting" discretion or error is more dramatically illustrated by reference to the "net income" which is in dispute here. The "net income" of $2,445,548, based on the average apportionment of .4429% of Exxon's "net income" to Wisconsin, represents only *.00899%* of the Appellant's 27.183 billion dollars of gross receipts for the years in question (Exh. 28, A766, A768, A770, A772). It represents approximately a 2% error in the assignment of Appellant's "net income" to marketing.

In addition, as heretofore indicated, while the Appellant's testimony centered on the "gross receipts" aspect of its "separate accounting," it produced no evidence either as to how its centralized administrative overhead, which exceeded one-third of its total gross receipts (presumably a large part of which is interfunctional transfers by the supply department) was allocated, apportioned or assigned to the various operating departments. This fact, coupled with the discretion and judgment involved as to the interfunctional assignment of "gross receipts" by internal accounting procedures plus the fact that we are here dealing with "net income" demonstrates the unreliability in this case of using Exxon's "separate accounting" as a constitutional due process standard.

D. Construction Of Wis. Stat. § 7.07(1) and (2) Which Requires The Inclusion In Apportionable Income Of Exxon's Income From Its Exploration And Production Operations Conforms To Both Due Process and Commerce Clause Restrictions On A State's Taxing Powers.

All of the unitary decisions referred to above in subdivision "B" of the Argument portion of this brief at pages 63-83 demonstrate that there is no merit to Exxon's argument that the inclusion of the income which it derives from its internal transfer of crude oil production in apportionable income for Wisconsin income tax purposes violates either the due process or commerce clause. This due process of law argument of Exxon is on no different constitutional footing than its argument that income from its refining properties or out-of-state marketing properties cannot be included in apportionable income. All of the unitary cases (property tax, franchise net worth, and income tax cases) discussed in subdivision "B" of this brief clearly indicate that out-of-state properties, values and income may be taken into consideration in the apportionment of a unitary tax base among the respective states in which the taxpayer conducts its business operations. The only due process requirement is that such properties or income or values constitute a part of the unitary trade or business of the taxpayer conducted in part in the taxing state.

Nor is there any merit to the multiple taxation commerce clause argument of Exxon. This Court has consistently held that if a tax is fairly apportioned to reach only that part of a tax base reasonably attributable to the taxing state, multiple taxation limitations of the commerce clause are satisfied. It has never invalidated a properly apportioned state tax on the grounds that it exposed interstate commerce to the *risk* of multiple taxation. In *Moorman Mfg. Co. v. Bair, supra*, this Court held that the prevention of any duplicate taxation would require uniform national rules for the division of income, both as to apportionment and specific allocation (separate accounting), which was not mandated by the commerce clause. It further held in *Moorman*, consistent with its holdings in *First Federal S & L Assoc. v. State Tax Commission*, 437 U.S. 255 (1975); *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959); *General Motors v. Washington*, 377 U.S. 436 (1964); and *Standard Pressed Steel Co. v. Department of Rev. of Washington*, 419 U.S. 506 (1975), that in no event would it strike down a reasonably apportioned state tax by reference to speculative and unsubstantiated claims of duplicative taxation. As this Court stated in *Moorman*, after rejecting the proposition the commerce clause precluded any risk of duplicate taxation:

> Finally, it would be an exercise in formalism to declare Appellant's income tax assessments unconstitutional based on speculative concerns with multiple taxation. (437 U.S. 267 at 280)

In *Moorman*, in further response to alleged duplicate taxation there involved, this Court specifically found that:

> . . . *[T]his record* does not establish the essential factual predicate for a claim of duplicate taxation. (437 U.S. 267 at 276)

Again, in *First Federal S & L Assoc. v. State Tax Commission, supra,* this Court declined to invalidate a state tax based on claims that more than one state could tax the interest income of a savings and loan association as "wholly speculative and unsupported by evidence in the record." (437 U.S. 255 at 262)

Wisconsin has thus not transgressed due process or commerce clause limitations by including in apportionable income for Wisconsin corporate privilege tax purposes the income Exxon derived from its exploration and production operations, even though the properties to which such income was attributable by Exxon were located physically without the State of Wisconsin. This is particularly true when as here only the internal transfers of Exxon's crude oil is taken into consideration.

CONCLUSION

For the reasons developed in this brief, it is respectfully submitted that this Court should affirm the decision of the Wisconsin Supreme Court below. Exxon has the due process burden of establishing by clear and cogent evidence that the Wisconsin corporate privilege tax measured by "net income" has subjected any income, properties or values to tax which are not related to Exxon's Wisconsin activities and sources. It has failed to meet this burden. Exxon's "separate accounting" of its marketing profits in accordance with accepted accounting principles and in accordance with Exxon's internal management policies, fails to establish that Wisconsin has measured its corporate privilege tax by apportionable "net income" unrelated to Exxon's Wisconsin privileges, activities and income sources.

The fact that Exxon has not met this burden is supported by the following considerations:

1. Any reasonable interpretation and application of the facts in this cause clearly establish that Exxon conducted a vertically integrated unitary petroleum business by and through all of its operating departments for the years in question; and that it conducted a part of such business in the State of Wisconsin for the years in question.

2. Exxon made no profit until its products were sold to its marketing operations.

3. Since the "separate accounting" result relied upon by Exxon in this cause is a matter of Exxon's management policy determinations, obviously, Exxon has the ability to change the same at any time in its sole discretion and judgment. Therefore, the tax result it here contends for as a matter of due process of law is entirely within its control.

4. Exxon's "separate accounting" was dependent upon theoretical and hypothetical sales of its crude oil, natural gas and manufactured products to third parties. It was not based on any verifiable objective standard. Exxon's "separate accounting" results were dependent upon what transfer prices were determined appropriate by its supply department. The transfer prices were not the result of any independent determination, accounting or otherwise, by its various operating departments. Thus, centralized management and control determined any "separate accounting" results.

5. In ascertaining "net income," any slight shift in this "separate accounting" result materially affected the assignment of "net income" to the various operating departments of Exxon.

6. While Exxon sought to justify its "separate accounting attribution results by reference to "posted field

prices" for crude oil, "Fiske-type" formula for natural gas and "Platt's oil gram" for manufactured products, these references pertain only to assignment of gross receipts. *There is no evidence* as to the method used by Exxon to *assign* all of its *expenses* which were deducted to arrive at the separately accounted for "net income" of its operating departments. Furthermore, the evidence establishes that Exxon's reliance on "posted field prices," "Platt's oil gram" and "Fiske-type" formula were only used to *guess what Exxon might have received* in gross receipts from hypothetical transactions with third parties, which of course never took place.

7. The fact that Exxon relied solely on the conclusionary testimony of its expert witnesses and the hypothetical results of theoretical third party transactions at "arms' length" conclusively demonstrates the lack of any objective proof to substantiate the "separate accounting" of its "net income" to its various operating departments.

8. *But for* Exxon's marketing activities in Wisconsin, no one knows what Exxon's profits would have been for the years in question.

9. The foregoing considerations amply demonstrate the fact, as specifically found by this Court in *Butler Bros. v. McColgan, supra,* that "separate accounting" does not impeach the constitutional validity of the reasonable apportionment of the unitary income of a unitary trade or business. Furthermore, this Court's holding in *Hans Rees', supra,* and its dictum in *Moorman Mfg. Co., supra,* in no way conflicts with the holding of *Butler Bros.* that "separate accounting" is not of controlling significance here.

10. Exxon's "situs income argument" has no constitutional validity inasmuch as the states may take into account out-of-state properties, income and values associat-

ed with in-state properties and activities in determining the validity of an apportionment result within the purview of the due process clause of the United States Constitution. Here only production "net income" from innerfunctional transfers was included in apportionable income. Thus, only hypothetical production income has been included in apportionable income.

Respectfully submitted,

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